Wrong Ideas or Vested Interests? The Role of Economic Perception in Macro-economic Policy Making

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I. Introduction

The purpose of this paper is to examine the role of wrong or misleading economic ideas that catalyzed the financial catastrophe in the interwar years and may have ultimately deepened or even prolonged the stagnation of the Japanese economy during the 1990s. Currently, the penetration of economic thinking into political science has generated the following paradigm: all agents are motivated by self interests, notably economic interests, and the force of conflicting interests interjected through political parties is more essential than any technical interventions of bureaucrats.[1] While we do not argue against this basic framework of political economy, we find two significant examples in Japan's macroeconomic history during which erroneous thinking rather than conflicts of interest misled the policy decision-making. This paper seeks to reexamine the role of preoccupied perceptions regarding economic policy making.

Since 1990, the Japanese economy experienced a prolonged recession that was aggravated by continuing deflation during the past several years. Macroeconomic theory, which has been taught with the assumptions that accompany existing inflationary pressures, is reexamined under a deflationary environment. Along with economics, economists are under scrutiny as to whether or not they can apply consistently the same economic logic in a deflationary situation as they do in an inflationary situation.

[*] We owe much to Frances Rosenbluth for her thoughtful discussions and criticisms on our approach..

[1] Gary Becker (1983) and George Stigler (1971) are among the influential articles along this line emphasizing that politicians and bureaucrats are also optimizing their objectives in the political markets. Ramseyer and Rosenbluth (1998) apply this view to Japan's political economy and claim, contrary to the conventional view of stressing the role of bureaucrats, that politicians, principals, are more influential than their agents like bureaucrats.

The general equilibrium approach to macroeconomics suggests that deflation, the decline in the general price level, is a monetary phenomenon simply because the general price level is a reciprocal of the price of money measured in terms of bundles of goods. One of the basic reasons that continuing deflation combined with recession during the 1990s was the miscalculated, too sudden, monetary contraction after the asset price boom, or bubble, in the late 1980s. As FED economists admit (Ahearne, Gagnon, Haltmaier, Kamin, Erceg, Faust, Guerrieri, Hemphill, Kole, Roush, Rogers, Sheets, and Wright, 2002), the BOJ had good reasons for offering excuses for the error because the situation was very rare in the postwar world economy. Thus, in order to cope with the problem, the first resort is to utilize monetary policy, and, as it happened, if conventional monetary policy does not show effectiveness immediately, new instruments of monetary policy should be examined and tested. Needless to say, we never discount the merits of microeconomic reforms including deregulation and the clearing of the outstanding, enormous, nonperforming debt.[2]

To our surprise, many policymakers, journalists, policy economists (*ekonomisuto* in Japanese) and even economists in Japan during the deflationary period have argued that deflation is a microeconomic structural problem. There are many credos: “Deflation is not a monetary problem.” “Deflation should be remedied not by monetary policy but by government expenditure policy.” “The fact that deflation originated from technological innovations and from inexpensive imports is a blessing.” Even further some of them claim: “Deflation should not be halted by monetary policy or exchange-rate policy because deflation helps the Schumpeterian creative destruction.”

One of the authors of this paper was in the government for two years from 2001-2003 and was in a position to watch, and partially to engage in the process of designing and effecting macroeconomic policy under deflation. The other participated actively in macroeconomic debates in academic and journalistic venues and argued against the doctrines that seemed to contradict the basic economic principle in macroeconomics. Both of us have come to be concerned about the serious consequences of economic illiteracy. We would like to stress the importance of the proper understanding of economics in determining macroeconomic economic policy.

In macroeconomics, most policy issues have clear implications regarding the welfare of a constituency. In macroeconomic issues, the incidence of economic policy is much less clear. Hardly anybody would doubt that the reduction of high tariff rates hurts the welfare of rice farmers in the

[2] This delinquent debt problem came, of course, partly from real decline in productivity in the Japanese economy, but also from the monetary shocks and resulting asset market crashes (See, Sheard, 2001, Hamada, 2004).

short run. In the field of microeconomics, the public has little difficulty in understanding who gains or who loses from a certain proposed economic policy. Group-oriented and sectarian interests can be developed and represented by various groups and agents in a country. On the other hand, as it happened, many in Japan believed that deflation would bring prosperity to the economy in contrast to the conventional knowledge in economics.

We had a grave experience in history that caused serious consequences in the lives of the Japanese during the inter-war years of the 1920's to 1930s. Policy makers as well as a majority of economists made misjudgments in the understanding of macroeconomic policy effects during the great depression in the 1920s and 30s. Many of them, with the notable exception of Tanzan Ishibashi, Kamekichi Takahashi and a few others mostly at the *Toyo Keizai Shinpo* (the *Oriental Economist*), believed wrongly that deflation on the return of the gold standard would cure structural problems during the inter-war years. The government took a bold step and returned to the gold standard with the old parity that had prevailed before World War I. The results were serious depression, deflation, and unemployment during those periods – the combination of which could very possibly have driven Japan into World War II.

During the last ten years, the Japanese economy made almost exactly the same kinds of mistakes and indulged in the same kinds of debates. It is a pity that a nation suffers from deflation not because of the conflict of social interests but because of ignorance or misguided thinking with regard to sound economic logic. In other words, it is not necessarily the restraint from conflicting interests but primarily the misperception of the economic universe on the part of economic actors, policy makers and some economists that exacerbated the deflation and recession of the 1990s. This paper aims to explore the consequences of mistaken but firmly held ideas concerning economic policy making, by focusing on the case of Japan's interwar period and the case of post 1990s recession.

In Section II, as a positive theory, we contrast the two views regarding the determinants of economic policy. One view stresses the interests of sectors, groups, politicians and government officials. The other view stresses the preoccupation, ideas and epistemological culture (Haas, 1992; Blyth, 2002). While we do not deny the significance of group interests and accompanying incentive mechanism in Japan's political scene, we would like to emphasize the importance of the conceptual or epistemological aspect of policy formation processes. The role of ideas and mistaken ideas has been relatively neglected in recent literature, and should be taken into account, particularly in a field where the incidence of policy actions is far from clear and accordingly professional knowledge needs to be taken seriously.

In Section III, we briefly review the literature that contrasts the power of vested interests of various actors and groups in policy making with the power of ideas. We explore the possibility of how the role of perception can be explicitly introduced into decision theoretic models.

Then, in the subsequent two sections, we present two examples that illustrate what we consider to be, wrong ideas that misled the Japanese economy. The first example (in Section IV) is the erroneous notion, popular during the interwar years, that the return to the gold standard with the pre-World-War-I old parity would restore strength to the economy. We analyze the opinions in newspapers and other media that show how prevalent this notion was. In Section V, we present the second example, that is, the policy making in deflationary Japan after 1995. For this period, there is ample data on the editorial opinions from which we can develop an interesting comparison between the two periods.

In the concluding section, we begin discussions on the two questions that are to be answered by further research. One question is: Given that some ideas were wrong and misleading for macroeconomic policy, were these ideas generated independently, or as a result of manipulation by pressure groups? The second question is: How, if at all, can our approach to stress mistaken ideas be embedded into the science of policy advising? (See Frankel. 2003).

II. Wrong Ideas vs. Vested Interests

As a positive science, economics attempts to understand the mechanism of the economic universe. At the same time, economics is used as a tool to derive a sound economic policy. Moreover, certain logical arguments or frameworks (including models) are used to justify a certain policy action.

Since economic policy affects the interests of many groups in a nation, economic policy making in the real world cannot be solely guided by the logic of economics. A specific economic policy has a different impact on different groups in a society. Pursuit of economic logic in the process of economic policy making is interfered with by the consideration of specific interests. Even if a policy is considered to be beneficial to a nation, the interest of a particular group may be harmed so that group will block the implementation of such a policy. For example, free trade is considered to be beneficial for a nation as a whole, but some interest groups may strongly oppose it for their own particular reasons.

The importance of interest groups is emphasized by many authors in the field of political science. The so-called "liberal international political economy" (See Putnam, 1885; Moravcsik (1993), for example) is a systematic academic pursuit of this line in the field of international relations.

Admitting the importance of the role of interests, we would like to stress in this paper another aspect of economic policy making, that is, the role of ideas. Economists trained in sound economic tradition agree that deflation as well as inflation is a monetary phenomenon and that monetary policy is the most effective policy assignment. Often, those basic principles are not incorporated in the general understanding of the public. Those principles are not only not understood but also ignored by politicians, mass media and policy makers. In such circumstances, the proper economic policy will rarely be chosen no matter how effective the monetary policy would be in order to cure deflation or inflation.

One uses the word "vested" interest in the context when, one possesses a privileged position or one considers something to be one's inert right. Similarly, we could use the word "vested" idea because one finds it difficult to abandon a particular idea if that idea preoccupies one's mind. Since wrong ideas, however, do not necessarily share the sense of exclusivity --- rather purveyors of the ideas welcome their dissemination, we will call this phenomenon "mistaken ideas" or "wrong ideas" when its logic is erroneous.

We do not deny that vested interests in policy making are important, particularly in areas like in the area of trade policy or particular regulation, where the consequences of particular policies to group interest are clearly observed. What we contend is that in an area like macroeconomic policy where the consequences of policies are either uncertain or unclear to the public, the role of wrong ideas cannot be negligible, and the incidence of wrong policies based on mistaken ideas can be extremely costly.

We would like to identify the relative roles of vested interests and vested ideas. If vested interests obstruct the formation of sound economic policy, then we have to propose a way to reconcile the conflicts of interests among groups. As Nicholas Kaldor showed (Kaldor, 1939), when there is a gain in the total national economy, say through free trade, there will be a proper means of transfers, from those who gain to those who lose; the wellbeing of all the groups will be improved. On the other hand, if the formation of a sound policy is obstructed by the consequence of ignorance and misunderstanding, the most important role of economists is to persuade and enlighten the public with the correct economic logic.

Our working hypotheses are that economic policy making is affected not only by vested interests but also by ideas, often preoccupied, mistaken or wrong ideas, and that the incidence of wrong ideas is serious where the benefit and cost consequences are seen as ambiguous by the public. In the choice of exchange rate regimes, and in the choice of monetary rules, for example, people often have mistaken ideas not only about the benefit and cost of policy decisions to a certain group in a country, but also about the benefit and cost of policy decisions to the economy as a whole. It becomes crucially important to correct or modify the mistaken ideas about the economic mechanism.

In the following two important examples of the Japanese economy, we highlight the role of ideas. One is the return to the gold standard and its reversal at around 1930, the policy choice between alternative international monetary regimes. The second is the policy debate concerning the deflation period since the second half of 1990 when the issue was the appropriate policy choice for the economy under deflation. In both periods, politicians, policy makers, journalists and economists engaged in heated discussions. In both periods, we compare the trends of newspaper opinions, as common indicators of general understanding and opinions.

III. The Role of Perception and Ideology in Policy Formation

As is well known, the two polar views are expressed by Keynes, e.g., the last chapter in Keynes' *The General Theory of Employment, Interest and Money* (1936) (Keynes, 1978), and by Stigler (1971). Keynes' statement that highlights the power of ideas in spite of short-term or medium term interests is so famous that we even hesitate to reprint here[3]. Stigler, on the other hand, stresses the effectiveness of incentives and individual interests in the political market. If we were to proceed further in this line, ideas and perceptions would be reduced ultimately to the interplay of interests since the pursuit of interests is the driving force of the political as well as economic markets.

We would like to clarify some of the related context. Years ago, Karl Marx defined "ideology" as a collection of ideas that are structured in such a way so as to enable the group holding power to have maximum control with minimum conflict. According to John Lye (see his Website), ideology can be imposed on others by deliberate persuasion or coercion to alter people's consciousness, but ideology can exist without any deliberate attempt to pressure acceptance. Ideas are made convincing by making them appear natural or "legitimate," or by derivation from historical tradition or intrinsic

[3] "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." (Keynes, 1978, p.383)

logic, or externalized as the common knowledge people are supposed to follow.[4]

The prevailing international relation theory, rational choice theory, is considered the approach to emphasize the role of conflicting interests. As for domestic economy, political scientists, sociologists, and economists have been influenced by this formulation. In addition, the modern treatment of principal-agent relationships enriches the framework.

Ramseyer and Rosenbluth (1998) successfully applied this approach to the political economy process in Japan. They examined the relationship between principals, typically voters and legislators, and agents, typically bureaucrats, as critical to the understanding Japan's political economy. They noticed that the "agency slack" in this relationship determined the ease or difficulty in channeling political wills to actual policy making. This view is easier to observe recently where the autonomy of even the allegedly most powerful Ministry of Finance, has come under political control.

If we consider these models carefully, we seldom find the emphasis on ideas (for an important exception. Blyth (2002)). The emphasis of ideas is, however, not in principle contradictory to the rational choice theory. Rational choice is conducted as optimizing or satisfying (a la Simon) behavior under constraints. Perception is a crucial precondition for the rational choice. Decision units are behaving under a system of the world view where their decisions will affect the outcome. The view may be common knowledge to all, or may be different from agent to agent depending on the idiosyncrasy of an agent, or where an agent belongs. However rational each agent may be as motivated by her or his economic motive, an agent's decision can differ depending upon what kind of view she or he has concerning the mechanism of the economic universe.

Some political scientists are well aware of the importance of ideas. John Campbell (1992) traces the role of ideas to the endogenous development of economic problems like the government budget and the institution like the social security system in Japan. Interestingly, he writes that "policy ideas are like charged particles, however, although they can be found in isolation, they tend to attract their opposites. (Campbell, 1992, p.50)"

Mark Blyth is among the few writers who explicitly emphasize the role of ideas. He proposes five hypotheses: (1) In crisis, ideas reduces uncertainty; (2) By reducing uncertainty, ideas make collective action and coalition building possible; (3) In the struggle over existing institutions, ideas are weapons. (4) After delegitimation of existing institutions, ideas act as institutional blueprints; and

[4]By the way, Karl Manheim contrasted "ideology" as the ideas to keep the *status quo* and "utopia" as the idea to provoke changes. This distinction will not be developed in this paper.

(5) After institutional construction, ideas make stability possible. Most of these are reasonable and should be subject to empirical tests. Also one should not neglect the existence of ideas that create disorders and even revolutions. His following statement is, however, highly convincing: "Cognitive mechanisms, *pace* ideas, are important because without having ideas as to how the world is put together, it would be cognitively impossible for agents to act in that world in any meaningful sense, particularly in situations of Knightian uncertainly ---. (Blyth, 2002, p. 32)"

Our position differs from Blyth's in a few aspects. First, as the title of his book, <u>Grand Transformations,</u> suggests, his work treats many "grand' shifts in social policies and institutions, while we pay attention to rather technocratic policy issues that encounter deflation and depression. Second, economic theory criticized as the "wrong" theory in his book, could at a certain time, become an appropriate theory for recovery of the economy.[5] In spite of these reservations, we find the direction of Blyth's approach quite promising.

We do not doubt the general applicability of the principal-agent view of the political economy in the large view. What we intend is to point out the necessity of taking account of the crucial role of economic perception in order to understand the success or failure of macroeconomic policies. There are at least three additional grounds to resurrect the role of ideas in political economy.

First, the degree of "slack" in this principal agent relationship noticed by Ramseyer and Rosenbluth is crucially affected by the perception and policy knowledge held by political and bureaucratic actors. As Dixit (1996) demonstrates analytically, the efficiency of the principal agent relationship in the government is affected by the degree of asymmetric information and by the existence of independent objective that the government as an agent possesses in addition to the objectives assigned by principals. The difference in perception between principals and the agent as well as the existence of inaccurate ideas will make this slack larger.

Second, as Frankel and Rockett (1988) emphasize, it is important for countries to share common understanding about the macroeconomic mechanism in order to achieve successful international policy coordination. If a government views the world within a monetarist framework, and another government views the world within the Keynesian framework, then the collaboration would not work. Any policy coordination attempts will encounter difficulties if economic models conceived by nations essentially differ from each other.[6]

[5] Some economists who are cited favorably in Blyth (2002) may not agree that deflation is a monetary phenomenon.
[6] This phenomenon is not necessarily unique for international policy coordination. Even within a country

Third, in a context of international relations, Haas (1992) juxtaposes the approach that emphasizes ideas, to the rational choice approach. For an international institution or for the international community to work smoothly, at least a certain degree of common perception must be shared by the members. An international community thus functions as the "epistemic" society as defined by Haas.

Of course, an epistemological society, or club, may actually be a hurdle for new comers or an obstacle against introducing new innovations. If the epistemological requirement works as a protocol that suppresses new innovations it may turn public goods to public restraint. For better or worse, an epistemological society may work as the instrument of displaying "soft power" by the incumbent countries. For example, the plan to build an Asian Monetary Fund by Japan was rejected, not only because of the mere difference between the interests possessed by Japan and those possessed by other developed countries, but also because the IMF had established a solid epistemological community.

We need to learn much form cognitive psychology when we study what brings about the change in perceptions. The Bayesian way of treating a change in belief from prior probability to posterior probability after observations is a traditional view. On the other hand, the phenomenon of "cognitive dissonance," (Festinger, 1957; Akerlof, 1982) tells the opposite. According to that view, individuals are reluctant to recognize the observation that is contradictory to one's belief because they do not like the inner conflict between one's belief and new observations.[7] One does not change perception easily unless it happens in such a way that one avoids the discomfort arising from the conflict between one's beliefs and new coming observations. The same kind of resistance to a change in ideas is seen in the discussion of the "paradigm" by Thomas Kuhn (1963).

We attempt to restore the recognition of the importance of ideas in a policy choice of an administrator, a political choice of representatives, and an economic choice of a private agent. To repeat, we admit that each policy maker or each politician behaves more or less on his (her) own selfish ground. However, if perception of the economic universe is different among agents, and often erroneous, the aggregate outcome can be distant to the desirable outcome. Our hypothesis is: the contribution of preoccupied ideas is serious where the benefit-cost consequences are ambiguous to the public. For example, the benefit-cost structure about the choice of exchange rate regimes or about the choice monetary rules is not perfectly clear to the public.

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if models perceived by various agencies are different, the same will take place.

[7] In the current election, one may find it unsettled or uncomfortable to see a particular channel, may it be the Fox Cable News or the CNN depending on one's political propensity.

If the ideas are important, then it is beneficial for a group of people to change the ideas that another group of people possesses. Ideas work as ideologies in the sense used by Marx. The modern world will then become a world of competition for ideas and for images. A game-like situation will emerge about how to imbed the most beneficial ideas to the related parties. The examples below in our paper seem to indicate, however, that often ideas themselves work as triggers to economic policy. Indeed, ideas may be manipulated by vested interests. When the matter is highly technical, as in the case of the return to the gold standard or liquidity preference, wrong ideas can function alone as detrimental for successful macroeconomic performance as our analyses below will demonstrate. Moreover, if most of the actors act on inaccurate beliefs and misleading frameworks in viewing the world, then the policy outcome will be different from what is desirable for the ultimate, legitimate principals of the economic, i.e., the individual actors in a nation.[8]

IV. Returning to the Gold Standard: A Bitter Experience in the Interwar Years

IV-i. Economic Disaster Resulting from the Obsession to the Gold Standard

The reconstruction of the international gold standard after World War I (WWI) was a conspicuous example in economic history that manifested the danger of preoccupied ideas in policy choices. It was a matter of great concerns for industrialized countries after WWI how they would rebuild the international gold standard. In fact, this issue was on the main agenda both for the Brussels Conference in 1920 and the Genoa Conference in 1922. Eventually, most of the countries decided to return to the gold standard at the prewar parity and implemented that decision.

At the beginning of 1920s, the discussions of how to restore the international gold standard were still been confined to a rather limited circle. There the discussions were conducted by two different kinds of people; policy experts, politicians, and the public, on the one hand, and the leading economists, on the other. Even at this early stage, there was an insurmountable discrepancy between the opinions of the first group and the second. Politicians, policy officials, and journalists were mostly in the position that the early return to the gold standard at the prewar parity was a prerequisite for correcting the confusion from the war and restoring the normal economic conditions that prevailed before the war. On the other hand, some economists were strongly opposed to this conventional view. They included members of the leading economists at that time, for example, John Maynard

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[8] Hoover contrasts three great social philosophers whose thought delineated major currents in the 20th century. The subject of this paper is at less grand levels, that is, about ideas in terms of technical understanding of economic logic.

Keynes, Irving Fisher, and Gustav Cassel. These economists thought that the return to the gold standard, if to be done at all, should be carried out at a devalued parity that was calculated for each country reflecting the current relative value of the currency to gold. Some of them went so far as to contend that the gold standard system itself should be modified or replaced by a certain more rational currency system. Fisher (1913), (1920) advocated the “compensated dollar” plan that purports to stabilize the dollar price of basket of goods and services, i.e., the general price level, by appropriately changing the dollar price of gold. Keynes in his *Tract on Monetary Reform* (1923) (Keynes, 1971) argued for the managed currency system without gold, an idea which became popular later.

An economic reasoning behind these economists was quite simple and straightforward, and it can be summarized as follows. During the World War I, many countries were forced to suspend the gold conversion of their currencies. The war obliged them to create vast amounts of government expenditure which must ultimately be financed by central banks. In order to make this scheme possible, most of the countries could do nothing but abandon the gold conversion of their currencies, that is, the primal discipline for conducting monetary policy[9]. In the process of this money financing, the monetary bases of these countries had inevitably expanded. As a result, many countries came to suffer from fierce inflation immediately after the war. Generally speaking, moderate monetary tightening by central bank is the most efficient way for suppressing inflation, and usually it is enough. It was not enough at that time, however, if a country in this situation aimed to restore the gold conversion of its currency at the parity that had existed before inflation. Such a country had to contract drastically its monetary base to the extent that it was sufficient to restore the price level before the beginning of WWI. Deflation and economic stagnation associated with it would be an inevitable consequence of necessitated monetary contraction. From the long run view, this process of deflation is a process of monetary adjustment, and would be regarded only as transitional and temporary. The economic distress would be eventually mitigated and relieved as the prices were reduced enough. Nevertheless, the necessity for such policy of monetary contraction and deflation was quite dubious. These economists argued that what was important for each country was not to restore the previous value of its currency, but to stabilize the currency around its existing value. The restoration of the gold standard at the prewar parity was, therefore, a policy option that could only harm the economies by deflation. To sum up, in order to stabilize the value of a currency, they argued that it was sufficient to restore the gold convertibility of a currency at its present value.

[9] The gold standard system was, above all, a system of rules for the member countries to conduct their monetary policies. For a systematic representation on the "rules of the game on the international gold standard system," namely the policy rules that were prevalent in the period of the international gold

Unfortunately, this reasoning by those economists, though it was enlightening and right from retrospect, was hardly accepted outside academia. It was considered by the general public as academic eccentricity, and never taken seriously by policy makers. This is shown most apparently by the fact that a large majority of the countries returned to the gold standard not at devalued parities but at prewar parities[10]. What occurred to these countries after the restoration was, however, exactly the situation that had been anticipated by the economists, i.e., severe deflation and stagnation with increasing unemployment[11].

One important fact to be recognized with this historical episode is that the countries making these decisions, i.e., to return to the gold standard at the prewar parity, had usually made it with a strong public support. Apparently, there was what we call a preoccupied idea on the side of the public. And that idea was quite contradictory to that of experts, namely, economists. Unfortunately, it was not the economists' thinking but the preoccupied, mistaken idea that dominantly affected the actual course of policies during the restoration phase of the international gold standard.

As shown above, those economists at that time had accurately predicted the disastrous outcome that would be generated by the policy of returning to the gold standard at the prewar parity. Significance of this prediction is highlighted by the "international view" on the Great Depression, the modern view developed by Temin(1989), Eichengreen(1992), Bernanke(2000), and the others[12]. According to their view, the gold standard rebuilt after the WWI was exactly the one that constituted a prerequisite for the world economic crisis that followed after. The logic goes as follows. Under the

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standard system from 1879 to 1913, see McKinnon(1993).

[10] The general proposals of the Genoa Conference on 1922, to which Keynes made some contributions, appropriately affirmed the option of a devaluation by a member country when necessary. However, Keynes had to make strong accusation to the officials of member countries attending there: "Signor Peano, M. Picard, and M. Theunis, speaking on behalf of Italy, France, and Belgium, announced, each for his own country, that they would have nothing to do with devaluating, and were determined to restore their respective currencies to their pre-war values. Reform is not likely to come by joint, simultaneous action. Experts of Genoa recognized this when they 'ventured to suggest' that 'a considerable service will be rendered by that country which first decides boldly to set the example of securing immediate stability in terms of gold' by devaluation," (Keynes, 1971a, p.118n)

[11] The most typical example was the case of Britain after 1925. At this year, Winston Churchill, then the British Chancellor of the Exchequer realized Britain's return to the gold standard at the prewar parity with overwhelming public support. Immediately after this, Keynes, who had always been at the forefront of the oppositions to the restoration of the gold standard at the prewar parity, published a pamphlet to criticize this policy. This book titled *The Economic Consequences of Mr. Churchill* (1925) (Keynes, 1981, 5) successfully predicted economic difficulties that occurred to Britain after that, namely, deflation, unemployment, and social turmoil. This is probably one of the reasons why Keynes compared himself to Cassandra, ignored prophetess in Greek mythology, in his preface of *Essays in Persuasion* (1931) (Keynes, 1972).

[12] It is Eichengreen and Sachs (1985) that provided a momentum for this research program. Temin(2000) concisely summarized the shared understanding of this framework

gold standard system, every country must tighten the money if gold reserves flow out. Therefore, monetary tightening by one country for the purpose of securing gold reserve would inevitably lead to monetary tightening by the other. A same mechanism would be provoked if a country attracting gold from outside tried to prevent its monetary base from expanding by sterilizing the inflow of gold. In brief, the international gold standard system has an indigenous tendency for mutual monetary contractions. The worldwide diffusion of depression at the 1930s was nothing but a realization of this systematic monetary tightening process, meaning that negative monetary shocks were transmitted in chain from one country to another through an outflow of gold that triggered additional monetary tightening. The most apparent evidence for this hypothesis is that no country could escape from being involved in deflation while adhering to the gold standard. As Bernanke (2000, ch.3) has shown, it was not until a country abandoned the gold standard and ensured a freedom of monetary expansion that the country could find a way to escape from the depression.

These studies of the last two decades on the Great Depression suggest that the insight of economists who had made an opposition to the restoration of the gold standard at the prewar parity was correct even more than they themselves thought it at that time. Conversely, a general idea at that time, i.e., a notion that the gold standard system was an indispensable prerequisite for economic stability, was wrong, and more harmful that used to be thought before. It was exactly the wrong idea that paved the way to the world economic crisis that generated unprecedented economic disaster in the human history.

IV-ii. The controversy on the restoration of the gold standard and its consequence

Japan seceded from a feudal state and started as a modern national state at “Meiji Restoration” on 1868. In the process of its industrialization and militarization, Japan fought the Sino-Japanese War of 1894-1895 with China. Japan won it and got reparations from China as a result of it. With this fund obtained, Japan moved from a gold and silver bimetallic standard to a genuine gold standard, meaning that Japan became a part of the international gold standard system prevailing in the world at that time. Although Japan was not a major belligerent of the WWI, it followed the other countries by suspending the gold conversion of its national currency on 1917. As soon as the war ended, therefore, the problem of returning to the gold standard, namely the question of how and when it should be done, became the policy agenda of national priority. However, it is not until 1930, the year in the midst of the world economic crisis, that Japan made a return to the gold standard after a long series of debates.

As similarly as the countries which made their decisions to return to the gold standard in the 1920s, extensive debates on this problem were made in Japan while it was apart from the gold standard. The controversy there, which involved both academics and journalism, was called “kin kaikin” (repeal of gold embargo) controversy in Japan. The repeal of gold embargo at that time was synonymous with a return to the gold standard since it meant a resumption of gold conversion from the currency and outflow of converted gold. The picture of this controversy on the repeal of gold embargo, which is one of the most heated controversies throughout the whole Japanese history, was also completely similar to that of the other countries. On the one hand, there were a small number of economists who made a strong opposition to Japan’s returning to the gold standard at the prewar parity. On the other side, there were a number of people, dispersed both in academics and in journalism, who believed recklessly in the need to return to the gold standard at the prewar parity. It is not without saying that the latter had constituted a dominant majority in the controversy.

If there was a peculiarity compared to the cases of other countries in this Japanese debate on the gold standard restoration, it is probably a fact that the economists opposing to the restoration of prewar gold parity were not professors in universities but economists working for private companies. The four most conspicious figures standing out of this camp were Tanzan Ishibashi, Kamekichi Takahashi, Toshie Obama, and Yasuzumi Yamazaki. These people, sometimes called as a “gang of four” for the devalued gold parity restoration, were all economists or journalists who used to write articles and editorials for economic magazines and newspapers. On the contrary, most of the economics professors in Japanese universities were supporters for the prewar gold parity restoration. The representatives of them were Kiichi Horie, a professor of Keio University who published an article titled “Let the depression proceed to its utmost end” in 1925, Seibi Hijikata, a professor of the Tokyo Imperial University who published a book titled “The repeal of gold embargo” in 1929, Tokuzo Fukuda, a professor of the Tokyo Commercial University who was one of the most prominent economic scholars at that time, and Hajime Kawakami, a professor of the Kyoto Imperial University who was a pioneer of Marxist economics in Japan. Economic scholars for the devalued gold parity restoration such as Senjiro Takagi, a professor of Keio University who had studied economics and obtained a doctorate under the auspice of I. Fisher, were quite exceptional.

The fact that most of the economists for the devalued gold parity restoration were not academic scholars doesn’t mean that their economic knowledge and their capability to understand economics were inferior to their opponents. The truth was just the opposite. These economists were far more familiar to the contents and the context of the debates developed overseas on the subject of restoring the gold standard. Actually, it is initially from the arguments by Keynes, Fisher, Cassel, and the other foreign economists in the same camp that Tanzan Ishibashi and Kamekichi Takahashi, the two most distinguished economists in Japan at that time, learned and obtained a theoretical basis for their opposition to Japan's prewar gold parity restoration.

Just before the Genoa Conference in 1922, Keynes wrote an article titled "The Stabilisation of the European Exchanges: A Plan for Genoa," that showed his own proposal for reforming and reconstructing the international gold standard system that had broken during the WWI. This article was finally published in a series of special supplements of his own edition to the Manchester Guardian Commercial. At the Genoa Conference, Keynes worked for the Financial Commission with the other experts as Ralph Hawtrey and Sir Robert Horne, then the British Chancellor of the Exchequer. They drafted the general proposals of the Commission. At this occasion, Keynes also edited twelve volumes of the "Reconstruction in Europe" supplements to The Manchester Guardian Commercial, a series of newspapers published only from April 1922 to January 1923. This series contained Keynes' own articles that were to make a core of his *Tract on Monetary Reform* (1923), as well as the other significant writings of Arthur Pigou, Irving Fisher, Piero Sraffa, and Gustav Cassel. It was not long before the contents of this series reached Japan. The Toyo Keizai Shinpo (the Oriental Economist), 10 June 1922, published a summary article of Keynes' "The Stabilisation of the European Exchanges: A Plan for Genoa," in The Manchester Guardian Commercial, 20 April 1922. It was Kamekichi Takahashi, then an in-house writer of the Oriental Economist, who wrote this summary on Keynes' idea. This brief article by Kamekichi made a commemorative first spur for subsequent arguments on the devalued gold parity restoration in Japan.

As shown in this episode, the opponents to the prewar gold parity restoration were always intellectually prevailed over the proponents in the intellectual battle field of the controversy. However, this superiority in the policy controversy didn't mean that the opponents were also superior to the proponents in the influence upon the actual policies. Above all, the opponents remained to be mere minority. Among the economic media, the Oriental Economist, that was a base camp for Tanzan Ishibashi and Kamekichi Takahashi, was the only journal which had expressed an overt support for the devalued gold parity restoration. The other journals and newspapers were virtually dominated by the arguments for the prewar gold parity restoration. Briefly speaking, they were dominated by the preoccupied idea.

After these heated debates, Japan eventually returned to the gold standard at the prewar parity on 1930. It was Jun-nosuke Inoue, then the Finance Minister of Osachi Hamaguchi cabinet, that initiated this task. Since its start on 1929, Hamaguchi cabinet had placed the task of returning to the gold standard as the primal policy subject of its own. On August 1929, the cabinet set out a large scale propaganda aimed at obtaining public support for the repeal of gold embargo and the tightening policies required for it. They used various means of public communication from radio broadcasting to distributing 13 million sheets of political leaflet. The public welcomed it, which was shown in an episode that “the repeal of gold embargo” motto became a fashion after that. Major newspapers at that time such as the Osaka Mainichi and the Osaka Asahi also welcomed this policy stance of Hamaguchi cabinet, and actively expressed the opinions in support of the government’s plan. This situation was quite natural since these newspapers had already been extensively involved in a voluntary campaign preaching “carry out the repeal of gold embargo right now.”

The thinking of Inoue, who completed the repeal of gold embargo by his own hand, can be easily seen in his booklets titled The Restoration of National Economy and the Repeal of Gold Embargo (1929) and The Repeal of Gold Embargo: An Appeal to all of the Nation (1929). He told in these books that “customary falsehood would remain if a temporary relief were made through the devaluation of gold parity,” “it would spoil people’s spirit to make efforts for the economic recovery, and result in a retreat from the original purpose of the repeal of gold embargo,” “we cannot avoid fiscal tightening and liquidation of business at least once in the process,” and “the wisest and the surest way is to go straight toward the repeal of gold embargo at the prewar parity since we cannot avoid some pains and some sacrifices anyway.” As will be examined later, these expressions of propaganda were typical rhetoric that had been frequently used in the arguments for the repeal of gold embargo at the prewar parity.

There is a famous anecdote that shows how common people at that time were got excited with this hard landing policy by Hamaguchi and Inoue. As a preparation for the repeal of gold embargo, Inoue traveled around the country to make a speech and to persuade the people of the need to endure the pains associated with this policy. At one of these occasions, an old lady attended there by chance was so deeply moved by Inoue ユ s speech that she threw a coin toward him. In a Japanese religious tradition, it is not an actual human but some symbol of God or Buddha that should be a target for coin offering.

As shown above, Japan’s return to the gold standard at the prewar parity was realized with overwhelming support of the public. However, the result was a disaster. What happened there was exactly the state of affairs that had been correctly anticipated by the economists, i,e., an unprecedented economic crisis associated with fierce deflation. This is what we call the Sowa Crisis. This economic crisis eventually leaded to a social turmoil as discontent of the people grew up. In such atmosphere, the prime minister Osachi Hamaguchi was shot by a fanatic fascist and seriously injured with this incident. After all, Hamaguchi cabinet collapsed as a result. Moreover, Britain abandoned the gold standard on September 1931. Since then, Japan had become a main target for speculative attack of selling Yen, which were provoked by an anticipation that Japan would leave the gold standard in the near future. In this circumstance, Japan was eventually forced to leave the gold standard again on December 1931, whose decision was made by Tsuyoshi Inukai cabinet established just before it.

IV-iii. Discussions of the restoration to the gold standard in Japanese newspapers

As we have seen, in Japan as well as in the world, there was a notable difference of opinions concerning he return to the gold standard between the leading economists at that time and others, i.e., politicians, policy officials, journalists, and the general public. It was exactly the difference between the idea based on the sound economic reasoning and the idea preoccupied to conventional thought, which we may call a "preoccupied" or vested idea.

Difficult questions are what is the substance of the vested idea, and how we can capture it. We can easily trace the opinions expressed by Keynes, Fisher, Ishibashi, and (Kamekichi and Korekiyo) Takahashi(s) by their writings. Similarly, we can trace the opinions of those, like Jun-nosuke Inoue, who cherished the restoration of the gold standard with the old parity by their addresses and writings. However, if the idea largely shared by the general public was far more influential to actual policies than the notion of these few extraordinary economists, we should pay more attention to public opinions. The difficulty here is that there is no direct evidence for the public opinion, or the vested idea possessed by people. Therefore we must find some proxy opinions that can be regarded as a good representation of the vested ideas of the public. We regard that newspapers can serve as an approximate, but proper proxies for the public opinion.

There are several reasons why we assume that opinions appeared in newspapers should be some reflections of vested ideas in the general public. A majority of readers for the major general newspapers are not social elites or intelligentsias, but ordinary citizens with average literacy. Therefore, newspapers are intended to have a social role of communication between the actual political field and the general public. Newspapers are always bringing information on policy subjects of national interests to various strata of people. Newspapers often express a specific opinion on a specific policy subject, and by so doing they evoke a broader understanding of the subject. In many cases, an opinion expressed in a newspaper is not the one held by an individual writer, but the "house view" that reflects a specific policy stance of the newspaper. It is precisely the case of "editorials" in Japanese newspapers. In many instances, views and opinions expressed in newspaper editorials are good representations of public sentiment. Since newspapers are also commercial media, they must represent at least some aspects of the public opinion in order to survive in the market.

There are various interactions around the editorials and other opinions of newspapers. Newspapers emulate the general opinions or sentiments of the public. On the other hand, newspaper may attempt to change the general opinions of the public. If the latter channel is workable at all, then politicians, administrators, business circles and even NGOs will try to influence the newspaper opinions. In this study, we emphasize the first channel, but further research is needed on the mutual interdependence and the strategic behavior surrounding the newspapers.

Muneyoshi Nakamura, a historian from Daito Bunka University, has made an illuminating research. Nakamura made an extensive survey into editorials regarding the return and the repeal of the gold standard in *the Osaka Mainichi* (*Daimai*), one of the representative newspapers at that time, from the year 1927 to 1932. He chose these years so that it covered all the critical periods that the controversy was most heated. During this period, repeal of gold embargo, suspension of the convertibility of gold, and a drastic change toward an expansionary fiscal as well as monetary policy was made by Korekiyo Takahasi, the Finance Minister of Tsuyoshi Inukai cabinet. A part of Nakamura's research was already published in Iwata((2003) ch.3). We owe Muneyoshi Nakamura for all the following citations which we translated into English here.

On 25 June 1928, France returned to the gold standard. The next citation is an editorial appeared in the following day.

> "Editorial: France realized the repeal of gold embargo: Japan should shame itself," *Daimai*, 6/26/1928.
> Now there remain only a few countries, Spain, Portugal, Greek, Mexico, and Japan that fail to realize the repeal. Why shouldn't we repent ourselves of being left behind if we think our nation is a civilized and first-rate one? . . . We don't need further arguments anymore. We now have seen good examples. We dare to urge the public to shame itself.

The most curious thing about this editorial is, in addition to the fact that the tone was very emotional, it completely neglected the fact that France returned to the gold standard at the parity devalued almost a fifth from its prewar parity. In this sense, this was an agitation rather than an assertion. Nakamura pointed out that this kind of solicitation or manipulation of the public was quite common at that time.

Around this period, advocacy for the repeal of gold embargo by the newspaper had become more emotional rather than rational as was seen from below.

> "Editorial: The lessons from the reduction of gold specie," *Daimai*, 9/10/1928.
> It is quite unnatural that Japan's economy continues to suspend gold convertibility. There is a reasonable fear that Japan's economy would gradually decline and eventually collapse. The only way we should take is to restore the gold export. It may be painful for a while, but it is a hopeful pain. Eventually it would restore us the normal and stable economic conditions.

On July 1929, Osachi Hamaguchi cabinet started. The cabinet immediately manifested to do the repeal of gold embargo, and appealed to the public for the need to endure tightening policies. The newspapers showed overall approval for it.

> "Editorial: The public should support the rationalization" *Daimai*, 7/16/1929.
> If we enforce these tightening policies and make them work, we must endure the greatest pain for a while. We will encounter many undesirable phenomena such as downturn of business and increase in unemployment. However, they are necessary preconditions for restoring the health of business circles. People must endure a pain of surgical operation in order to cure disease. Shrink first in order to expand!

The phrase "shrink first in order to expand" was a rhetoric that the prime minister Osachi Hamaguchi liked to use in his speech that intended to appeal for the repeal of gold embargo. Before long, it became a familiar cliché that the newspapers loved to use. Under such a circumstance, Japan reached 11 January 1930, the day of the repeal.

> "Editorial: The day for the repeal of the gold embargo has come. Be prepared for a full of difficulties before us," *Daimai*, 1/11/1930.
> In order to win the international economic battle, we must reduce our national debt in the fiscal side. In the private side, we must rationalize our industries by reducing costs. . . . We hope to transform this memorable day for rehabilitation into the first day for us to step forward to the fundamental reform of the public and the private economy.

Contrary to the hope, the situation of Japan's economy deteriorated fast after the repeal of gold embargo. Facing with this change of the circumstances, the tone of arguments in the newspapers gradually lost its previous vigor, and became more and more defensive.

"Editorial: A curse is useless for the recession," *Daimai*, 5/11/1930.

No one is pleased with a recession. Many people are so suffered from the recession that they started considering the repeal of gold embargo as a wrong policy. These people now expect a revival of monetary expansion policy. We ask them to reconsider the things more seriously.

As mentioned before, Japan had suffered from speculative attacks by sales of the Yen since Britain abandoned the gold standard. At this occasion, the newspapers argued against speculators that speculation is essentially wrong. Needless to say, these speculative attacks against the Yen were only the result of the anticipation that Japan would be unable to maintain the gold standard any longer.

"Editorial: Maintenance of the gold standard," *Daimai*, 11/3/1931.

Recent outflows of gold from Japan are not the same as those from Britain and Germany because outflows from Japan do not come from foreign withdrawal of short term capital but from speculations by traders in the exchange market. Now that Britain has been suspending the gold standard and Japanese capital is frozen there, it is to be permitted for someone to send gold to the United States to obtain funds for payment. However, this measure should have a definite limitation. . . . It is apparent that some traders are intentionally buying dollar with speculative purposes. Speculation is a conduct intended to make unfair profit by infringing the national interest, since it would increase the nervousness of businesses and eventually lead to the suspension of gold export again.

Speculative attacks to Yen had made Japan's gold reserve decline fast towards exhaustion. Consequently, Japan released itself from the gold standard system again on December 1931 under Tsuyoshi Inukai cabinet. Soon after that, Korekiyo Takahashi, the Finance Minister of Tsuyoshi Inukai cabinet, developed expansionary fiscal and monetary policies that were the boldest in the world at that time[13]. This policy contributed gradually to the recovery of Japanese economy, and finally made it recover from the world economic crisis. At the first phase of this period, however, the newspapers were quite skeptical and critical to this recovery policy that depended on such expansionary macroeconomic policies.

"Editorial: The limit to monetary expansion," *Daimai*, 6/20/1932.

Recent policy for inflation is intended to make the value of money lower and the prices of goods

[13] Hugh Patrick made a clear estimation to the matter as follows: "It was inevitable that Japan should go off the gold standard, as it did in December 1931. What followed probably could not have been anticipated: one of the most successful combinations of fiscal, monetary, and foreign exchange rate

> higher by issuing more currency. The recovery obtained by such a policy is not a real recovery that would come from restoration of business activities. . . . Some measures for relief of business might be needed. If it went so far as to step forward an excessive expansion of money, however, this policy would break the foundation of our currency system, and ruin all of our businesses. We admit that the government should take some measures for relief in order to settle this difficult situation. We eagerly hope at the same time that the government should make every possible effort to contain the inflation within a certain appropriate limit, and to avoid various harms that would be generated by inflation.

Around the end of 1932, however, the newspapers came to recognize the rational and the forward-looking merit of Korekiyo Takahashi’s policy.

> "Editorial: A reflection on business" *Daimai*, 12/31/1932.
> We can notice that more and more countries in the world have been moving toward a policy of reflation in order to resolve depression since the beginning of this year. Incidentally, our nation is running the forefront of this stream. Although it is quite difficult to predict what this stream will bring about in the end, we have clearly realized that its net benefits costs in this transitional period seems to be substantial. The problem for the next year is how we can minimize the fiscal, economic, and social costs of the ongoing policies, and pave a road toward a true restoration of the balance in government finance and the growth of the private economy.

IV-iv. Significance of a cognitive gap in policy making

The lessons obtained from the above survey of this representative paper can be summarized as follows. At that time, there were apparently two vested ideas or myths on the repeal of gold embargo. The first myth was the notion that the legitimacy of a currency could not be guaranteed unless the country is in the gold standard system. Most of the media were arguing about the currency system without gold convertibility as if it were an unnatural and abnormal system. And they supported the restoration to the gold standard as if it were a return to the natural state. Many discussions were precisely reflecting this notion. This is what Eichengreen and Temin (2000) named as the "gold standard mentality," which was quite prevalent all over the world at that time.

The second, quite conspicuous, notion was that the soundness of an economy would be secured only through a painful process of competitions and survivals, that is, through the risks of bankruptcies in the market. This sort of thinking may be properly named as the "liquidationism" or the idea of

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policies, in an adverse international environment, that the world has ever seen," (Patrick, 1971, p.256) creative destruction[14]. This mentality seems to explain the reason why the people at the time asked for the restoration of the gold standard at the prewar parity and not at the devalued parity. The people knew, at least vaguely, that the restoration of the gold standard at the prewar parity would necessitate macroeconomic tightening, which might generate deflation. Nevertheless, the people preferred the painful prewar parity to a painless devalued parity. This is apparently a reflection of the liquidationism that soundness can be obtained only through pains.

As shown above, mistaken or preoccupied ideas played a crucial role during the episode of Japan's return to the gold standard. What has become clear in the public and in the popular news media is sometimes more influential for actual policy making than the idea deduced from a rigorous framework shared by experts. The result is serious especially when these two ideas are contradictory each other. Ideas by experts are often more reliable and secure than that of the common public who are novices in economics. It is the very existence of cognitive gap between the experts and the public, however, that obstructs the adoption of reliable and desirable policy and keep the government to follow the wrong policies for a long time. The restoration of gold standard done by many countries after the WWI illustrate precisely the loss incurred by national economies resulting from wrong policies that were taken because of the existence of cognitive gap between experts and the common preoccupation.

V. Defining "Conventional Wisdom" or "Preoccupation" on Deflation

V-i. The Long Stagnating Japanese Economy under Deflation

Another good example to illustrate the relationship between policy formation and preoccupation of ideas is the public perception and policy responses toward deflation in the late 1990s in Japan.

Japan's economy has gone through unprecedented long period of deflation since the late 1990s. After the burst of bubble economy in the late 1980s, the Government and the Bank of Japan (BOJ) succeeded to contain the rise in Japan's consumer-price-index (CPI) and the asset prices started to

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[14] Historically, the most famous phrase that properly defined the spirit of the liquidationism is the one uttered by Andrew Mellon when he was the Secretary of the Treasury in the Hoover administration during the Great Depression: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. . . . Even a panic is not altogether a bad thing. It will purge the rottenness out of the system. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people." Bradford DeLong pointed out that this kind of thinking could be also seen in the statements on the Great Depression by some famous economists such as Joseph Schumpeter, Friedrich Hayek, and Lionel Robbins. They maintained at the nadir of the Great Depression that the greatest danger the economy faced was inflation. Ralph Hawtrey told that it was the equivalent of "Crying, 'Fire! Fire!' in Noah's flood." (DeLong, 1997)

decline rapidly. Partly thanks to the appreciation of Yen, the CPI increase rate has dropped to negative range in 1995. Although inflation rate did recover slightly for a short period of time from 1996 to 1997 (a part of it is the statistical tilt caused by the hike of the consumption tax from three to five percent), economic downswing in late 1997 put Japan's economy almost in a continuous state of deflation (Figure 1). Downslide in the consumer-price became so serious that the Bank of Japan (BOJ) decided to go along with the zero interest rate policy. CPI declines and asset-price declines continued despite the zero interest rate policy and after the suspension of the zero interest policy in August 2000 after heated debates. From 2001 to 2002, Japan's already deflationary economy floated around minus one percent line in terms of the CPI and lower rate in terms of GDP deflator. During this period, Masaru Hayami, Governor of the BOJ who presided over the position for five years since March 1998, was succeeded by March 2003, Toshihiko Fukui. Since then, downward trend of the CPI seems to have decreased and is now approaching in the zero percent range.

Under the deepening process of deflation, Japan's economic growth rate continued to stagnate. From 1992 to 1994, real growth rates of Japan's GDP were consistently below one percent. It eventually dropped to a negative range in 1998. At the same time, jobless rate steadfastly increased in the early 1990s, rising from 2 percent in 1990 to 5.4 percent in 2003. In other words, Japan's deepening deflation was accompanied with debilitation of real economy, such as declines in the growth rate and increases in the jobless rate. One attributes the name of "Japan's lost decade," which depicts the situation quite accurately.

The causes for this long stagnation are under a serious debate among numerous scholars and business economists. We hardly have room here to delve into the details of the debate. It is clear, however, that diminishing GDP growth rate and heightening jobless rate were strongly tied to the continuing deflation during the period. And, deflation was, needless to say, closely associated with monetary contraction.

Japan's money supply as well as its monetary base increased dramatically during the bubble period of the late 1980s to the early 1990s (Figure 2). The increases in those two monetary concepts resulted from the persistent effort by BOJ to maintain low interest rate policy in order to prevent appreciation of the Yen against the US dollar, which began after the so called Plaza Accord in 1985. After Yasushi Mieno became a governor of the BOJ in 1989, the BOJ launched an aggressive policy to raise the interest rate aiming at blowing up the bubble economy. As a result, the call rate, which was at that time BOJ's policy rate or the operation target, rose from 3 percent in 1989 to 8 percent in early 1991 (Figure 3).

The mass media applauded in the initial phase for BOJ's aggressive policy of monetary contraction position lead by governor Mieno in order to halt blow up the asset bubbles. He was hailed as the Onihei (Shylock Holms equivalent in the Edo city) in modern times. As can be seen in Figure 2, the credit contraction after 1990 was causing a sharp decline in the money supply and monetary base from behind the scene. Facing this situation, the BOJ decided to shift its policy from credit contraction to credit easing in spring of 1991. Since then, BOJ gradually kept lowering its policy rate. Yet, in retrospect, the speed of easing the credit was far too slow to match the scale of monetary shocks, which had taken the forms of sudden decline in money supply and monetary base[15]. Inflation rate did not stop sliding down despite the lowered policy rate. Because of diminishing inflation rate, BOJ had to lower the policy rate. In the end of 1995, the policy rate was lowered to unparalleled 0.4 percent (Figure 3).

The fact that the policy rate was approaching the level implied that BOJ had lost its conventional means to implement monetary policy. For a while, the expanding economic situation during year 1996 and early 1997 obfuscated the problem. The seriousness of this problem became obvious in late 1997, when the economy returned to a serious shape once again, and the inflation rate slipped to below zero. In other words, Japan's economy was falling into the "deflationary trap."

When the rate of price change keeps declining, the central bank usually lowers its policy rate to stop it. But, in the situation as the policy rate has already hit the zero mark or in near the mark, central bank cannot use its traditional instrument to cope with the problem. Consequently, deflation deepens

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[15] During this critical period of early 1990s, there was sharp division of opinion between BOJ economists and several economists, notably Kikuo Iwata, Seiji Shinpo, Takahiro Miyao, and Yutaka Hrada, who criticized BOJ's sluggish move toward monetary easing. In retrospect, those who criticized BOJ had far more valid points. Studies done by Jinushi, Kuroki, and Miyao (2000), Ahearne et al. (2002), McCallum(2001) identified the problems of Japan's monetary policies during 1990's. Those studies pointed out that BOJ's reluctance in monetary easing from 1993 to 1994 was the immediate cause of Japan's prolonged deflation. Ahearne et al. (2002) points out that "The 1993-94 period may have been particularly crucial for monetary policy, since that is the last time (with the exception of the short-lived response to the VAT hike in 1997) that inflation rates exceeded zero by a reasonable margin, so that a sufficiently large drop in the policy interest rate could have generated very low or negative short-term real interest rates. After the beginning of 1995, zero or negative inflation rates largely undermined the effectiveness of monetary policy by limiting the extent to which the real interest rate could be lowered." (Ahearne et al., 2002, p.13).

further, and deflationary expectations intensify. Inevitably, one observes the increase in the real interest rate, which is defined as the nominal rate minus the expected rate of inflation. The increase in the real rate of interest discourages consumer spending and corporation investment. Therefore, shrinking total demand in the macro economy further worsens the deflation. Japan's economy after the end of 1990s was about to fall into the self-sustaining deflationary process.

Despite the deepening deflation, the BOJ, led by Masaru Hayami who was appointed Governor in March 1998, tended to indulge in the wait-and-see attitude toward deflation. There were some exceptions inside the BOJ. In particular, Nobuyuki Nakahara, a member of monetary policy deliberation committee, advocated aggressive credit easing policies. He was, however, never able to win the majority inside the BOJ board. The economy was already recovering from the recession in Feburary 1999 when the BOJ decided to introduce the zero interest policy. Although the BOJ went with the zero interest policy at that time, the central bank considered the policy as somewhat "abnormal." They were eagerly waiting for the timing to depart from this unusual zero interest policy situation. In 2000, BOJ leaders decided to end the zero interest policy though deflation was still pervasive in Japan's economy. They were afraid of losing the policy instrument of manipulating the interest rate as a part of the tradition policy measures. The harm from deflation was probably considered less serious than the loss of the interest rate control.

V-ii. Division of Opinions on Deflation and on Proper Policy Responses

The unusual situation in Japan's economy, that is, the prevalence of deflation under the zero interest policy drew substantial attentions from scholars abroad as well as at home. Many ideas were presented concerning how to bring Japan's economy out from "liquidity trap," the first case since the world economy was under great depression. For instance, Krugman(1998), Bernanke(2000), and Svensson(2001) were among those scholars who expressed their ideas on the issue. These scholars had significant influence on the policy discussion in Japan just as the opinions by Keynes, Fisher, and Cassell had affected the debate regarding Japan's return to the gold standard.

In any case, there were serious differences in opinions among Japanese scholars concerning what is the best policy for the Japanese economy to escape the deflationary trap under the zero interest rate policy. On the one hand, some scholars agreed with the argument made by scholars abroad mentioned in the previous paragraph. They advocated introduction of even non-traditional monetary policy devices such as the inflation target, expansionary fiscal policy, the exchange rate policy aimed to depreciate (at least resist the appreciation of) the Yen, and or the combination of these policies.

On the other hand, there were scholars expressed their skepticism on taking further measures toward expansive macroeconomic policy and in particular, monetary policy. They claimed that there is no room left for exercising traditional policy measures to ease the credit. The financial system has become dysfunctional because of accumulation of nonperforming loans. The government budget deficit already reached the critical level. Therefore, they argued, one cannot expect much from macroeconomic policy.

For all that differences (differences in such questions regarding the effective measures and the way to implement them if they exist), a majority of academic economists seemed to share a basic agreement. That is, deflationary economy had to be overcome since it had devastating effect on the economy.

It has to be noted that the agreement only existed among those experts, and that the agreement did not extend further to outside circles including the mass media. Indeed, the negative effect of deflation was seldom noticed outside the scholarly circle, and the necessity to overcome deflation was rarely discussed. Instead, until recently, the major part of the discussions among journalistic circles was to appraise the “good deflation.” Much of the attention was paid to the extent how deflationary economy benefit consumers through inducing distribution revolution and more efficient method of production and to the extent how deflationary economy can alter Japan’s high cost structure. Deflation should be welcomed, according to them, since it is the result of great competition within global economy. Naturally, in such kind of atmosphere, scholars who advocated expansive monetary policy to breakaway from deflationary economy were seen as promoting unhealthy inflationary policies. They were criticized and even teased by mass media.

Such kind of conventional wisdom or preoccupied ideas should have had an effect on Japan’s policy management. Despite the persistent and desperate warnings from considerable number of scholars about the danger of deflation, the government did not seem to recognize the importance of overcoming deflation and the implementation of policy package against deflation until 2002. In that year, because of the progress of deflation, it was beginning to be obvious for everyone that the deflation had much to do with stagnating economy. Unfortunately, people had to go through the pain of deflation to break a spell of “good deflation.”

Deflation had hardly drawn attention from the mass media until it became serious in 2001. Figure 4 shows the change in numbers of hits returned as a result of searching articles including a keyword “deflation.” The search was done by using database of Nikkei Telecom by counting the number of articles of nationwide newspapers (Asahi, Mainichi, Yomiuri, Sankei, and Nikkei). Other than 1995 and 1998 when inflation rate dropped to a negative range due to weak economy, deflation was rarely discussed in nationwide newspapers before 2001, when the cost of deflationary economy became serious.

The same tendency can be found for the frequency in the media’s attention on government’s policy formation. Figure 5 shows the similar statistics using two different keywords “structural reform” and “policy measures against deflation.” One can easily tell that from the spring to the summer of 2001 one of the keywords “structural reform” received huge attention from the media. This data reflect the course of events that in April of 2001 Junichiro Koizumi became a prime minister of Japan and that “Pain enduring structural reform,” the mantra of the cabinet, became a popular headline for newspapers. The enthusiastic media coverage on this mantra did not last long, however. In 2002, “policy measures against deflation” became another important mantra for the government. Especially, after the government introduced “comprehensive policy package against deflation” in October 2002, the number of hits of this slogan exceeded that of “structural reform.”

Not only the news media but the government shifted its policy emphasis. This can be confirmed by tracing the summary of the debates within the Council of Economic and Fiscal Policy (CEFP). This CEFP is “collegiate organization set up in Cabinet Office in January, 2001 with the aim of strengthening prime minister's political leadership in the matter of economic and fiscal policies.” This council is considered as a crucial organization for the purpose of setting the basic goals of Japan’s economic policy. The members of the council are Prime Minister, Ministers of economic ministries, Governor of BOJ, and four other members from the private sector. On the list of the titles for agenda of the Council meetings (http://www.keizai-shimon.go.jp/minutes/index.html), the word “deflation” came up only once in 2001. But, the frequency increased to six times in the titles in 2002 and became one of the most important policy agendas. The conference summaries of CEFP also confirm the shift in policy agenda[16].

There could be some differences in opinions among viewers in interpreting how much government’s shift in its policy stance did in fact affect the actual policy outcomes. Further research should address this question. For now, we would like to argue that the shift in conventional wisdom or preoccupation on deflation among the public was the prerequisite before the shift in government’s

[16] As Hamada (2004) shows, the initial atmosphere of CEFP was apparently influenced by “good deflation” theory. Thanks to ardent persuasion by some scholars, however, the atmosphere among the members of CEFP gradually changed as days (months or years) went by.

policy stance took place. In the next chapter, we will elaborate on this point by tracing the history of change in tone of newspaper articles during this most critical period of the Japanese economy, from the year 2000 to 2003.

V-iii. The trend in editorial opinions in major newspapers on the issue of deflation

In the following, we survey the trend of editorial opinions in three Japanese newspapers, the *Asahi*, the *Mainichi* and the *Yomiuri*, from year 2000 to 2003. According to the “Newspaper Publishers Report” published by Japan Audit Bureau of Circulations (JABC), the numbers of circulation of morning editions of these three major newspapers from January to June of 2004 were *Yomiuri* 10,075,479, *Asahi* 8,259,173, and *Mainichi* 3,956,348. Distribution rate per house hold of each three major newspapers adds up to 44.47 percent; *Yomiuri* 20.13 percent, *Asahi* 16.45 percent, and *Mainichi* 7.89 percent.

Table 1 shows the result of counting the number of editorial articles from 2000 to 2003 that contain the key word “deflation.” It is obvious that Yomiuri has mentioned the word far many more times than the other two. The persistence of Yomiuri in mentioning deflation was quite distinct. The reader may be reminded to assess the effectiveness of the opinions of the Yomiuri that the Yomiuri was reputed to have reflected the personal views of its owner, Tsuneo Watanabe.

Mainichi’s “pro-deflation” editorials expressed the opposite side of those in the Yomiuri. Nevertheless, as in following paragraphs, both sides criticized BOJ’s policy implementation under governor Hayami severely, although from the mutually opposite directions.

Among three major newspapers, the Asahi spoke for the average view of the media. The basic tone of Asahi’s editorials until the early half of 2001 was similar to the “advocating the good deflation” view appeared in the Mainichi. However, the argument gradually disappeared over time as deflation in the economy progressed. The Asahi started to advocate the necessity of overcoming deflationary economy during the middle of 2001. Still, it kept opposing the adoption of quantitative easing policy or the inflation target. In the end of 2003, Asahi altered its view drastically by publishing an editorial favorable toward a BOJ’s quantitative credit easing policy. Asahi’s change in the direction of its editorials was coincided with the policy shift of the emphasis of the government from “structural reform” to “anti-deflation.”

We will examine editorial articles of these three major newspapers during several sub-time periods.

(1) Until the end of zero interest policy: 2000-August 2000

Japan's economy was recovering in early 2000 although deflation did not show any sign of rebounding. The BOJ, which adopted the zero interest policy in February 1999, had announced publicly that it would continue the zero interest policy until "concerns for deflation" would disappear. Nevertheless, the BOJ never defined what was exactly meant by "concerns for deflation." This ambiguity in the wording for the conditions for discontinuing the zero-interest policy generated active debates regarding whether and when the zero interest policy should be discontinued. The debates continued until August 2000 when the BOJ actually decided to halt the zero interest policy.

The tone of the media during this time period is well represented by Asahi's 4 February 2000 editorial titled "Japan's abnormality is conspicuous", in which they told that the zero interest policy was abnormal and should be halted as soon as possible. An editorial by the Yomiuri, on the other hand, presented a contrasting view to the above in the Asahi. The Yomiuri was the only media to give a favorable view to the introduction of the "inflation target," which certain people in the government started to consider around the same period.

> "Editorial: A further argument for the inflation target is needed" *Yomiurii*, 2/5/2000.
> The Liberal Democratic Party plans to consider the feasibility of setting a so-called inflation target, a target for increases in commodity prices, and measures to achieve the target. . . . One year has passed since the Bank of Japan introduced zero-interest policies. Although more bright signs have emerged, the economy has yet to be put on a path to self-sustaining recovery led by private demand. To make sure that the economy recovers, it is necessary to implement more easy-money policies to increase the quantity of money in the market. A specific target set for the rise of commodity prices would act as a yardstick in carrying out such steps and would be effective in dispelling anxiety about deflation. It is hoped that vigorous debates will be held for an early introduction of an inflation target.

The tone of the Mainichi was quite similar to the one of the Asahi during this time period. The Mainichi was even more critical towards an expansive macro economic policy than the Asahi. The Mainichi, also, kept presenting its more "pro-deflation" view.

> "Editorial: A year of near-zero interest rates. We need to hike it" *Mainichi*, 2/10/2000.
> Almost a year has gone by since the Bank of Japan implemented an unprecedented policy of maintaining interests rates at levels near zero. Ultra-low interest rates have provided financial institutions with breathing room and allowed the economy to rebound and prices to stabilize.

The public, on the other hand, has grown accustomed to savings accounts that pay almost no interest. As a result, they no longer seem to find the energy to complain. . . . The central bank says it will raise the interest rate as soon as deflationary trends have been eliminated. But such a move would be a mistake. Instead, the Bank of Japan should immediately abandon its near-zero interest rate policy and quickly return the official discount rate to normal levels. . . . The Bank of Japan's policy of pushing the interest rate toward zero has been a fiasco. It is impossible to use the interest rate as a policy tool when it begins to approximate zero. That is why it is essential to take steps to immediately put an end to this nightmare.

Under the pressure to discontinue the zero interest policy from the news media, the BOJ started to pave the way to actually lift the policy. In July 2000, the end of the zero-interest policy was expected to be announced any time soon. But, the SOGO, one of the largest department stores, unexpectedly went into bankruptcy, and this incident prevented the BOJ from announcing its policy shift in July. Following editorials of Mainichi and Yomiuri are their reactions to the event and BOJ's decision to delay the termination of the zero-interest policy.

"Editorial: Is the BOJ spineless?" *Mainichi*, 7/18/2000.
While acknowledging that concerns about deflation have largely been dispelled, the central bank said that the potential fallout from the bankruptcy of Sogo Co., the department store chain, precluded it from raising interest rates at this time. A central bank that chooses to base its monetary policy on the fate of a single corporation is making a grave error, however. An amendment to the Bank of Japan Law was supposed to have bolstered the central bank's independence, but it continues to be concerned about the opinions of Japanese politicians and U.S. officials. This forces us to ask the question, does the central bank have a spine? The nation's economy will undergo major upheavals as it heads into the 21st century, and will eventually have to implement the structural reforms that were postponed throughout the "lost decade" of the 1990s. The tendency to procrastinate was encouraged by the central bank's ultra low interest rate policy. Structural reforms cannot be implemented without a normal monetary policy. In other words, it is essential that the nation put an end to the emergency zero-interest-rate policy and implement measures to ensure that a cost, namely, an interest rate, be attached to capital.

"Editorial: BOJ should keep zero-rate policy," *Yomiuri*, 7/18/2000.
Personal consumption has yet to regain vitality, although it accounts for 60 percent of the country's gross domestic product. Given this situation, nobody can be confident that worries about deflation will be eliminated in the near future, though that has been a major condition set

by the central bank for ending the near-zero interest rate policy. Depending on the outcome of the Sogo case, there is a strong possibility that a self-sustaining economic recovery led by private demand will be further delayed. . . . To begin with, we cannot find any reason to hastily end the zero-interest-rate policy. There is an opinion that maintaining the zero-rate policy may bring about moral hazard on the part of companies who depend on the policy and, as a result, painful but necessary corporate restructuring will be postponed. However, even if the ultra-easy monetary policy were to be lifted, the target of the short-term interest rate would be raised by about 0.25 percentage point. The central bank itself emphasized that the easy-money policy would be maintained even if the 17-month-old policy is abandoned. The theory that corporate management tends to act irresponsibly when interest rates are near zero but responsibly when rates stand at 0.25 percent does not stand up to examination.

In August 11th of 2000, the BOJ eventually decided to suspend the zero interest policy despite the opposition of the government. Following articles are the reactions to the decision by the BOJ. Again, Mainichi and Yomiuri took different positions on the issue.

"Editorial: Interest-rate hike. Only a step toward a normality," *Mainichi*, 8/12/2000.
Why, then, has so much fuss been made over the fate of this abnormal rate policy? One reason is that the Bank of Japan had allowed it to remain intact for so long. It was introduced in February 1999 as an ad hoc measure to effectively shield the central bank from having to purchase deficit-covering bonds. Even if the ultra-low rates helped slow deflation, they should have been raised back up immediately. The September 1998 lowering of the overnight call rate from 0.5 percent to 0.25 percent was itself an emergency step. Moving it back up to 0.25 percent still leaves the nation with historically low interest rates. Because the near-zero rate policy had been in place for so long, the government and many private firms had begun to accept it as normal. The Bank of Japan has only itself to blame for allowing the mood to become so widespread. . . . The latest move by the Bank of Japan is not sufficient, of course, to normalize the financial sector. Savings accounts, for example, would still earn next to nothing. This is but the first of many more steps the central bank must take; its next should be to bring overnight interbank rates back to at least 0.5 percent. Moreover, the government must not take the bank's decision lightly. Rather, it must work closely with the bank to nurse the economy back to health.

"Editorial: BOJ must win public confidence," *Yomiuri*, 8/12/2000.
The Bank of Japan decided Friday to end its zero-interest-rate policy as it believes the economy has reached a stage "at which deflationary concerns have been dispelled," which was its stated condition for lifting the policy. Doubts remain, however, about whether the decision was

appropriate. This is because consumption, a key driving force of the economy, has still not picked up steam, and the downward trend in consumer prices has yet to be halted. . . . Can companies whose management has sunk beyond hope be made to leave the stage without repercussions? It is necessary to tread carefully for the time being in the struggle to bring about an economic recovery. Ending the zero-rate policy should not be allowed to become a new destabilizing factor. . . . The central bank has a responsibility to make the utmost effort to prevent financial chaos by implementing policies promptly and flexibly. It is essential for the central bank to declare to the public, as well as the domestic and foreign markets, that it will continue its easy-money policy even when the zero-rate policy ends to secure an adequate money supply, and that it will not raise rates again for now.

(2) Reinstating the zero interest policy and the introduction of quantitative easing: from September 2000 - March 2001

After the BOJ suspended the zero interest policy, partly thanks to the worldwide economic slowdown, Japan's domestic economy started to decline again, and indicators of deflation became more serious. Under the circumstances, policy discussions focused on the policy instruments such as the introduction of an inflation target and the fight against deflation through depreciation of the Yen resurfaced. The Mainichi and the Asahi expressed their critical opinions concerning these policy measures.

"Editorial: Inflation targeting is the wrong way round," *Mainichi*, 10/29/2000.
The Bank of Japan has dug in its heels, rebuffing pressure from the Liberal Democratic Party and economists to adopt inflation targets in order to stem deflation caused by insufficient demand. The most important task of a central bank is to maintain the value of the currency, and price stability is essential for carrying out this task. The central bank believes that it can carry out its mission by releasing price forecasts twice a year -- without inflation targets. . . . It is important to realize that much of the price declines can be attributed to deregulation. If that is the case, price declines should be considered a positive development, which would be nullified by inflation targeting. And once inflation is triggered, it is difficult to bring under control. Central banks can establish various policies to stabilize prices but cannot manipulate prices in accordance with their whim. And once inflation gets underway, it rapidly devalues assets held by citizens. Central bankers have an obligation to prevent this from happening. It was only 10 years ago that Japan underwent a period of abnormally steep asset inflation. Why are people already clamoring for a new round of inflation? Adopting inflation targeting at this time would be reckless.

When deflation was deepening, and recession was becoming obvious to the public, the government decided to change the definition of “deflation” in order to make the definition conform to the universal use of the term. The government rephrased it from “an economic slowdown accompanied by decline in prices” to “a continuous downward trend in prices.”[17] Then, it went on to admit publicly for the first time since the end of WWⅡ as follows: “The current state of Japan’s economy is in mild deflation.” The following editorial pieces show the contrasting views of the Mainichi and the Yomiuri on this matter.

> "Editorial: Proclamation of being in deflation. Don’t stop the decline of prices," *Mainichi*, 3/17/2001.
>
> The government's monthly economic report issued on Friday acknowledged that the economy is in a state of deflation. The continuing decline in consumer and wholesale prices, in other words, has been construed as being undesirable. The drop, though, is largely the result of burgeoning imports, technological advances and the streamlining of distribution. Even services, long considered too costly compared to other countries, have been getting cheaper. The economy is shifting to a new pricing structure due to globalization and deregulation. The declaration of deflation was accompanied by a new definition of the term as "a state in which prices keep falling," deviating from the previous official description as "a state in which prices are falling while the economy is receding." Apparently it is a disguised demand to the Bank of Japan for further quantitative easing. It is an admission of the dearth of economic policy options left at the administration's disposal. There is no need to prop up prices; they should be allowed to drop further.

> "Editorial: Government in economic never-never land," *Yomiuri*, 3/17/2001.
>
> On Friday, the government revised its definition of deflation from "a state in which prices are falling while the economy is in recession" to "a continuous state of falling prices." At the same time, it officially recognized that the Japanese economy is in a state of deflation. The erstwhile government view that Japan was not in a state of deflation did not convince the general public, even as a deflationary spiral--a maelstrom of falling prices and recession that represents a malignant, advanced form of deflation-- was growing increasingly visible. The government can take a kudos for its revision of the definition of deflation and its recognition that deflation is happening in Japan--for now at least--as actions that provide an accurate grasp of reality of the

[17] One of the authors remember when Kazumasa Iwata, Director General, called him telling about the change in the definition of deflation in conforming to the world standard and to the logic he used in his policy writing.

> domestic economy. . . . Recognition of deflation is meaningless unless actual policies reflect the sense of crisis. The introduction of "an inflation target rate" is one measure likely to be effective in braking the price plunges that consequently contract production and consumption activities. Namely, the government and the Bank of Japan should carry out policies with the target of a certain price increase rate. The government must undertake a study with the central bank immediately on which indicators should be used and which levels are appropriate as concrete numerical targets.

Under the circumstances, on March 19th, BOJ decided to re-implement the de facto zero interest policy by putting a quantitative easing policy into effect. The followings are the comments by Mainichi and Yomiuri on the BOJ’s policy shift.

> "Editorial: BOJ goes back to zero, Monetary easing can’t be a substitute for structural reform," *Mainichi*, 3/20/2001.
>
> On Mar. 19, the Bank of Japan's (BOJ) Policy Board reinstated what is effectively a zero interest rate policy (ZIRP). This step follows two interest rate cuts implemented last month. Is the central bank attempting to enter into a "dialogue with the marketplace" a la Alan Greenspan, or are its actions directed at politicians? The Bank of Japan has decided to pursue a policy of monetary easing until the consumer price index stabilizes. In essence, the central bank has adopted the policy of inflation targeting that it had opposed until now. The BOJ also stated that it would step up its purchases of long-term government bonds. In theory, we should not be surprised that in this era of global deflation, policymakers are trying out novel approaches which depart from conventional practice. But when Japan jumps from one novel policy to another, it is telling the world that it has lost its composure. Japan must remember that it is not alone. All of the advanced industrialized economies are facing deflationary pressures. . . . And the Bank of Japan should be warned that its decision to embark on a policy of quantitative easing, which was recommended by the American economist Paul Krugman three years ago, is risky because its purchases of government bonds could eventually lead it into a "monetary hell" where it is forced to become an underwriter of the same debt. The case has been made, though not very convincingly, that a looser monetary policy will help to calm market jitters. It is important to realize, however, that increasing the money supply will neither ease the pain of structural reform nor take its place.

> "Editorial: Make best use of BOJ's decision," *Yomiuri*, 3/20/2001.
>
> Since the central bank lifted its zero-rate policy in August, it had consistently asserted that there

was no need for it to reinstate the policy nor for it to relax monetary policy in a quantitative manner. The Bank of Japan has performed an about-face because a situation has developed in which the Japanese economy may fall into a deflationary spiral that could trigger massive turmoil in the world economy. To avert the risk of a deflationary spiral--a chain reaction of falling prices and recession--the government must take full advantage of the central bank's decision. . . . The Bank of Japan has learned a bitter lesson. It rejected a government request that it postpone an interest-rate hike on the grounds that it would be premature to do so and went ahead with the suspension of the zero-rate policy. But only seven months later, it has been compelled to implement an unprecedented easing of its monetary stance. The latest decision by the central bank may be interpreted as a shift in its monetary policy made in line with changes that took place after the suspension of the zero-rate policy, such as the sharp slowdown of the U.S. economy. Yet it is obvious that the central bank made an error of judgment in hiking the interest rate when no signs of adverse effects from monetary relaxation, including signs of inflation, were visible.

(3) The period of gradual quantitative credit easing policy: from 2001 to January 2003

The implementation of quantitative easing policy by the BOJ raised the responsibility issue of Governor Hayami, who dared to introduce the zero interest policy in spite of government’s opposition in August 2000. The media reported in the April of 2001 that governor Hayami was considering his resignation. The following articles from Yomiuri and Mainichi both criticize governor Hayami on the issue, but it is interesting to note that reasons for behind the criticism are mutually completely opposite.

"Editorial: Hayami's mixed legacy at BOJ," *Yomiuri*, 4/28/2001.

The public has been well aware of what has taken place since last August, when Hayami took the initiative in ending the central bank's zero-interest policy despite strong objections from the government and the ruling parties. What ensued by a renewed economic slump in the economy. Faced with a serious deflationary crisis, the Bank of Japan brought its zero-interest policy back in place in March. Undoubtedly, the central bank proved itself to be an "independent" body under the new Bank of Japan Law when it forced the step of ending its zero-interest policy. However, the public and the market were disappointed that the bank just looked on without doing anything to contain the deflationary crisis. Rather, the bank was filled with a groundless fear that inflation could strike the nation. The nation's deflationary crisis is serious, as shown by a record 0.4 percent plunge in the consumer price index for fiscal 2000. In this sense, Hayami bears a heavy responsibility for his erroneous decisions about what was good for the economy.

> "Editorial: Hayami's waffling," *Mainichi*, 5/24/2001.
>
> In monetary policy, results count for everything. When the central bank adopted its policy of near-zero percent interest rates in February 1999, it explained the step as an emergency response to a financial system crisis. But on March 19 this year, the bank reverted to a policy of quantitative easing and hence rates approaching zero percent. Both short- and long-term interest rates have declined since then, but in spite of signs of a glut of funds in the short-term financial markets, corporate activity has not picked up. All told, it would be difficult to declare the policy of near-zero percent interest rates as a success. Some reports indicate that Hayami decided to stay on because he thinks highly of Prime Minister Junichiro Koizumi's reform program. But if the central bank continues to base its monetary policy on quantitative easing, it will simply delay painful structural reforms and hinder the weeding out of weaker industries. Hayami's denials notwithstanding, if rumors of his resignation persist, the market will turn its back on him. He bears a personal responsibility to take steps ensuring that monetary policy returns to a state of normalcy as quickly as possible.

Governor Hayami’s responsibility issue was obscured by the advent of Koizumi cabinet that set forth the structural reform as its top policy priority. Then, the topic of structural reform attracted an unprecedented fever from the domestic news media. Despite the fever on the structural reform in the media, the economic condition worsened. On August 14th, the first time since the BOJ had adopted the quantitative credit easing policy in March, the BOJ strengthened its credit easing measure.

> "Editorial: Steps should not be last," *Yomiurii*, 8/16/2001.
>
> The Bank of Japan explained the latest steps as measures to strengthen the foundations for economic recovery and to support the government's structural reform. In reality, the latest central bank measures came from a strong sense of crisis on the part of the government and the ruling parties as well as the recent plunge of the stock market. A series of recent monetary easing policies by the central bank, including the latest ones, inevitably leads one to imagine they are only minimal bit-by-bit steps. The Bank of Japan has to show a strong determination to fight deflation, and must make utmost efforts in that direction as the nation's central bank.

Since then, as deflation and depression continued to worsen, the BOJ was obliged to strengthen the quantitative easing measure little by little and step by step. In spite of BOJ’s effort, the situation did not improve, and again, the question of whether to adopt the inflation target measure became a subject of debate.

"Editorial: Inflation is no cure-all," *Mainichi*, 1/26/2002.

There are no proven formulas to fight deflation, however, and the Bank of Japan has already reached its limit on what it can do from the monetary side. This has prompted many to urge the central bank to announce a target for the rate of inflation and utilize all policy measures at its disposal to achieve such a target. Expectations of higher prices in the future would, it is reasoned, compel investors and consumers to spend more. Indeed, the BOJ decided last March to maintain its lax monetary policy until prices at least stopped falling. It has since been pouring money into commercial banks to trigger spending. There is nothing more it can realistically do. It is not possible, moreover, to willfully steer the exchange rate lower in order to boost Japan's exports and induce higher prices domestically. The exchange rate is determined by economic fundamentals, and tampering with it, as U.S. Treasury Secretary Paul O'Neill recently noted, can only weaken one's own economy. Instead of fighting it, the declining prices should be regarded as good news for consumers, and ways to boost demand should accordingly be considered. . . . The argument that problems would disappear if prices started moving back up is a faulty one. The government should focus on achieving a soft-landing to a new pricing structure and express a positive vision for the future, such as by boldly shifting budgetary appropriations around and encouraging companies and individuals to increase spending.

Asahi's line of argument was consistently critical to the inflation target, as Mainichi's. Nevertheless, Asahi's tone was changing over time. The Asahi no longer advocated the "good deflation theory."

"Editorial: Everyone must cooperate in the renewed effort," *Asahi*, 1/6/2003.

We do not disagree with those who say that mild inflation in the course of pulling the economy out of deflation would not be a bad thing. The problem is how that can be achieved. There is no specific or sure cure. If the Bank of Japan were to buy up corporate shares and properties without restraint, the result could be inflation. Such an approach, however, would not only worsen the financial position of the central bank, but would diminish public trust in the economy, leading to a plunge in the price of government bonds. There is also a danger that the result would be runaway inflation. And if that happened, much of the value of what people have worked so hard to put into savings would be lost. Similar results could come from application of a policy that promotes inflation by diminishing the value of the yen. Without cooperation of other nations, there is a limit to what can be done domestically that would lead to a conscious revision of the yen's value in relation to other currencies. Relentless pursuit of a miracle cure for the ailing economy could leave us with nothing but the negative side effects.

Another political focus during the end of 2002 to the early 2003 was about who will be the next governor of BOJ after Governor Hayami, who would retire in March 2003. Prime Minister Koizumi, in the December of 2003, expressed his opinion on the criterion for the selection of the next governor of the BOJ. The Prime Minister said “the one who possesses strong will to overcome the deflation is most desirable.” After the Prime Minister’s remark, Nobuyuki Nakahara, a former member of BOJ Policy Board and an advocate of inflation target, came up as a potential candidate for the next governor of BOJ. In 17 January 2003 editorial titled “The nomination of new BOJ governor: stupidity of hoping for ‘pro-inflation governor’,” Mainichi made a harsh opposition to it.

(4) The selection of the new governor, and the aftermath: From February 2003 to December 2003

The government eventually selected Toshihiko Fukui, the former vice-governor of BOJ, as a new governor of BOJ in February 2003. Following editorials are the comments concerning the choice.

> "Editorial: He needs to keep politicians at an arm's length," *Asahi*, 2/25/2003.
> Some politicians and academics continue to believe, if not so outspoken about it now, that a price-increase targeting policy would be the miracle cure. Some politicians, impatient that the central bank has not fallen under their sway, have even tried to again amend the Bank of Japan Law, which just a few years ago was fortified to give the central bank greater independence. If the central bank were to sacrifice credibility now as a result of politicians in pursuit of immediate benefit, the value of the yen would sink, exacting a severe toll on people's daily lives. While the government and the Bank of Japan should naturally cooperate in the fight against deflation, the nation's economic woes cannot be solved by having the government try to force the central bank to do with monetary policy what the government itself has not been able to do with fiscal policy.

> "Editorial: Restoring trust in the Bank of Japan," *Mainichi*, 2/25/2003.
> The nomination of a successor to Hayami has attracted a high degree of attention because of expectations that the next BOJ chief will help lead the economy out of its current slump. Prime Minister Junichiro Koizumi has stated that the head of the central bank should have a zeal for fighting deflation. Unfortunately, since the latter half of the 1990s, the BOJ's policies of near zero interest rates and quantitative easing have left its reputation in tatters, and the entire Japanese economy under a dark cloud. As the watchman of the currency, Fukui will be expected to steer monetary policy while refusing to cave in to politicians and the Cabinet, asserting the independence of the central bank called for in the new Bank of Japan Law.

> "Editorial: Fukui must try a new tack," *Yomiuri*, 2/25/2003.

Fukui, currently chairman of the Fujitsu Research Institute, a private think tank, will be expected to drag the Japanese economy, which is on the verge of crisis, out of deflation. If he is to do so, he will have to chart a new course for the central bank, departing from its traditional policies. We urge Fukui to listen carefully to the opinions of his new deputy governors--former Vice Finance Minister Toshiro Muto and Kazumasa Iwata, director general for policy planning at the Cabinet Office--and launch a counterattack on deflation by mobilizing unconventional policies. According to Article 2 of the Bank of Japan Law, the central bank's main mission is to stabilize prices. Thus, the central bank chief is tasked with fighting not only inflation but also deflation. . . . The nation's economic situation has deteriorated to such an extent that the central bank can no longer stand on the sidelines and say "the Bank of Japan alone cannot stop deflation." The new governor must note that nowhere in the world is there a central bank that is not charged with taking principal responsibility for stabilizing prices. Unless the person responsible for monetary policy--the central bank governor-- is determined to overcome deflation, it will be impossible to reverse the projection that the country will continue to be saddled with deflation.

Before Fukui became the Governor of BOJ, he was regarded as a candidate who would be reluctant to ease the credit as the former Governor. On the contrary, Fukui took the policy stance for aggressive credit easing measure into effect right after he became the Governor. In addition, the BOJ under Fukui's direction cooperated with Ministry of Finance in conducting a huge amount of exchange rate interventions that intended to minimize the abrupt appreciation of the Yen in the fall of 2003. The BOJ implemented the expansion of quantitative easing, in order to assure that exchange market interventions are unsterilized interventions. A following editorial is the comment from the Asahi, which shows clear shift in its tone.

"Editorial: Defeating deflation: The new cabinet has a big homework assignment," *Asahi*, 11/16/2003.

In its manifesto of campaign pledges presented prior to the recent Lower House election, the ruling Liberal Democratic Party stipulated a macroeconomic target of nominal GDP growth of 2 percent or better by fiscal year 2006. The defeat of deflation is imperative to attain this economic goal. Although prices have come down, there has been no similar drop in the amount of debt that must be repaid. This situation naturally intensifies the burden on companies and individuals who have taken out loans. This, in a nutshell, is the problem with deflation. Under the zero-interest deflation" existing in Japan today, real interest rates level off high. These factors inevitably act to curb personal consumption and capital investment. Prime Minister Junichiro Koizumi's new Cabinet, set to be inaugurated this week, will thus face this demanding

> homework assignment of coming to grips with Japan's deflationary spiral. The present focus of deflation-fighting measures is quantitative financial deregulation-in other words, an ultra-easy monetary policy. Last month, the Bank of Japan decided on a course of further expansion in fiscal relaxation, although objections were also raised to the idea of increasing financial deregulation during a gradual economic recovery. Among the nine voting members of the BOJ Policy Board, only six voted in favor of this course of action. The recent appreciation of the yen on foreign exchange markets is also bad news for an economic recovery. When the stronger yen is factored into the equation, the stress being placed on pumping money into the economy is understandable.

The Mainichi never abandoned the "good deflation theory." The Mainichi kept calling for the termination of zero interest policy.

V-iv. The Meaning of Conventional Wisdom on Deflation

As already stated, Japanese government placed priority to the "defeat of deflation" as high as to the structural reform among its policy agenda. Under such a political trend, the government appointed following three new members to the executive office of BOJ. They are, Governor Toshihiko Fukui and two deputy governors Toshiro Muto, a former administrative vice-minister of the Ministry of Finance, and Kazumasa Iwata, a Director-General for Policy Planning of the Cabinet Office and a former professor of Tokyo University. Because of BOJ's reluctance to ease money under the direction of governor Hayami, the BOJ had often disagreement with the government. However, this new executive office that started in March 2003 was successful in giving strong impression to outside world that the BOJ shared the same goal with the government in implementing aggressive monetary easing measure by itself[18]. Helped as well by the recovery of world economy, the

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[18] When the government selected Fukui as a new governor of BOJ, he was not welcomed by the foreign media. Fukui was perceived by many as a successor of Hayami, a former governor of BOJ who was extremely careful and slow on monetary policy management during his governorship. For an example, in an article "Japan's Great Hope (Aug.4, 2001)", *the Economist* recommended Prime Minister Koizumi to fire governor Hayami by accusing him as a lame governor who cannot or will not deal with deflation. Moreover, when Prime Minister Koizumi chose Fukui as a next governor, this time *the Economist* turned to PM and criticized his decision. In "Muddleheart Koizumi (Feb.27, 2003)", *the Economist*, with harsh criticism, wrote "What Mr Koizumi lost by this appointment was the chance to show that he really does want novelty, that he truly wants to change Japan." However, almost a year after the critical article appeared in *the Economist*, the magazine praised Fukui by calling him "the world's best central banker" in

seriousness of Japan's deflation started gradually to decline.

Although there were differences in their degree of incidence, the history of Japan's deflation and the policy responses of the government in the 1990s resemble those of Japan's Showa Depression. In both Showa Depression and the current depression, the deterioration of actual economic environment forced the government to shift its policy. In other words, the implementation of necessary policy measures had been constantly postponed and prevented until the crisis or near crisis because of the pervasive conventional wisdom. For example, the newspapers, based upon the "good deflation" theory, often encouraged the BOJ to lift its zero interest policy and criticized the government's effort to persuade BOJ to ease money. In order to overcome such conventional wisdom, it was necessary for the nation to go through further economic stagnation and to suffer resulting losses.

The "good deflation" theory, that was popular among the media, had four theses;

1. Deflation is a good phenomenon.
2. Deflation is not a monetary phenomenon but a structural phenomenon.
3. The causes of current deflation are globalization, deregulation, and technological innovation.
4. Depreciation of the Yen harms both Japan and the rest of the world.

It is obvious that all of these arguments are hardly accepted by the majority of economists.

Concerning the first thesis, economists do think that the changes in nominal variables such as deflation and inflation may be neutral to the real economy in the "long run." However, as long as the rigidity in nominal variables remains, the changes in absolute prices will affect the real variables. Therefore, if the nominal adjustment is inadequate, the deflation will be a primary cause to keep the economy below its potential level in the short run. Whatever the case may be, the deflation is not a

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"the Bank of Japan Thoshihiko Goldilocks (Feb.12, 2004)." It went on to criticize Masaru Hayami, a former governor of BOJ, by calling him a "possibly the world's worst central banker" who profess there is nothing BOJ can do while the interest is zero. Fukui, on the other hand, is clearly committed to aggressively pursue a quantitative easing policy until the inflationary economy is actually achieved. On this regard, Fukui has adjusted the BOJ's monetary policy to the right course, and *the Economist* recognized him as a better central banker than Alan Greenspan at America's Federal Reserve or Jean-Claude Trichet at the European Central Bank.

"good" thing to the real economy[19]. The "good deflation" theory simply confuses the absolute price change of goods and services with the relative price depreciations of a certain commodity due to an innovation occured there.

The second and the third theses are the core of good deflation theory. The question here is not the one whether real factors might affect the prices or not. As the identity equation of the quantity theory of money tells, if a quantity of money is constant, an increase in a real income inevitably results in deflation. Moreover, the analysis of aggregate demand and aggregate supply in a macroeconomics textbook shows that the "positive supply shocks" such as a price reduction of traded goods and a technical innovation would, by making a supply curve to shift rightward, lead to a depreciate the general prices. There is no problem in the analysis itself. The real problem of good deflation theory rests in the fact that it claims, beyond this kind of analysis, as if the monetary factors cannot affect the general prices. This claim is clearly wrong, since the absolute prices, or the general price level, are the relative prices of a currency to the goods and services. Therefore, the prices definitely depend on the supply of money.

The good deflation theory also tells that the deflation caused by a positive supply shock is good. This contention is also wrong. It is no doubt that a positive supply shock itself is a favorable phenomenon that would increase the real income. However, it does not mean that the deflation caused by the positive supply shock is also favorable. It is always possible to prevent the deflation with monetary policies even though a positive supply shock occurs. In general, a combination of the rise in the potential growth rate, which might be induced by positive supply shocks, and the adequate monetary policy implementation, which might prevent these shocks from leading to an excessive disinflation or a deflation, allows actual growth rate to be heightened to the most desirable level. The U.S. economy during 1990s called the "fabulous decade" (Blinder and Yellen, 2001) is the typical example that shows a successful result of this combination.

The problem of fourth thesis is that it neglects the facts that Japan's currency system is a floating exchange rate system, and under such system, the exchange rate is affected by endogenous variables determined by variety of macroeconomic variables. According to the classical open economy model,

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[19] If there is an economic theory that can justify deflation, that would be a Milton Friedman's "optimal rate of inflation" concept (Friedman, 1969). Since this optimal rate is given by a negative of real interest rate, an optimal inflation rate becomes negative as long as a real interest rate of an economy stays positive. However, as Woodford (2003, ch.7) argues, this kind of reasoning only works in a world in which nominal rigidities does not exist. That means this kind of world only exists in a hypothetical world. In fact, no single central bank in the world has set its goal for negative inflation rate based on this Friedman's rule.

the nominal exchange rate is determined mostly by monetary factors. The influence of nominal factors to the real economy is completely neutral there. In a Keynesian type of open economy model, such as a Mandell-Fleming Model, the depreciation of nominal exchange rate of one's own currency caused by a monetary expansion will increases the desirable external demand by depreciating the real exchange rate. The advocates of "good deflation" theory often define the phenomenon as if it were a beggar-my-neighbor policy. This perspective is incorrect, however. Under the floating exchange rate system, in which each country maintains the autonomy of monetary policy, each country retains freedom to implement similar measure of its own. With the monetary policy autonomy, each country can easily minimize the negative effects imposed by the depreciation of exchange rate of other country's currency. This process is mutually growth promotional, thus nothing to do with a beggar-my-neighbor policy[20].

A small number of Japanese economists had continued to maintain the fallacy of the "good deflation" theory from this reasoning. It is not clear, however, whether their efforts could effectively alter the conventional wisdom. At least before the period of 2002 when the deflation became serious, the "good deflation" theory apparently dominated the debate among the media.

VI. Concluding Remark

During the Showa depression, an economic policy of Japan shifted drastically from requidationalism through retuning to the gold standard at the prewar parity to a reflationary policy. Likewise, the Koizumi cabinet, which had advocated the structural reform, shifted its policy stance by declaring to put further effort to overcome the deflation as one of its primary policy goals. In both cases, the obstacle for the change was a conventional wisdom, which was represented by the media. The scholars' views on the issues were often conflicted with the conventional wisdom of that time, and the power of the scholarly views to influence those conventional norms was limited. Therefore, the negative effects that followed those obstacles had to become apparent before the conventional wisdom to wane and to yield to the favorable policy shift.

This phenomenon implies two important points on the relationship between economics as a social science and the society itself. On the one hand, from a falsificationism stand point, the phenomenon can be explained as a scientific phase. If there are several thesis or claims exist on a certain economic issue, the policy proposal with fewest flaws will be proven in real circumstances. The process is extremely important to enhance the reliability of the political application aspect of

[20] Eichengreen and Sachs (1985) have argued that recoveries of countries after the great depression were, indeed, the results of this mutual monetary easing.

economics.

On the other hand, this kind of confirmation requires huge social and economic costs. This becomes especially apparent in the situation that the conventional wisdom is extremely inflexible and the enlightenment by the scholars has no influence to the society. Keynes and Fisher, two prominent scholars and enthusiastic policy advocators, once tried to persuade and to enlighten the society in order to show the negative aspect of the restoration of the gold standard at the prewar parity. However, their claims did not easily accepted by the society, and as a result, the society incurred the great economic loss.

Sometimes, economics must overcome conventional wisdoms to effectively apply the knowledge that the discipline has developed overtime. Keynes once said that “the conventional wisdom, not the established interest, is the force that dictates the society.” He must have had the same idea in his mind. Unfortunately, no one has found the answer to this important question yet, and it will remain so in the foreseeable future.

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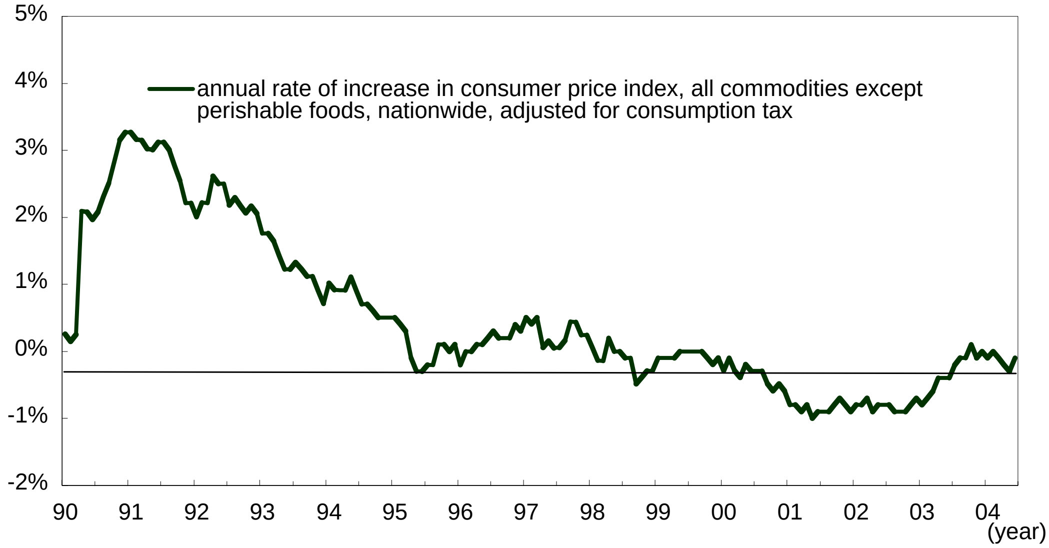
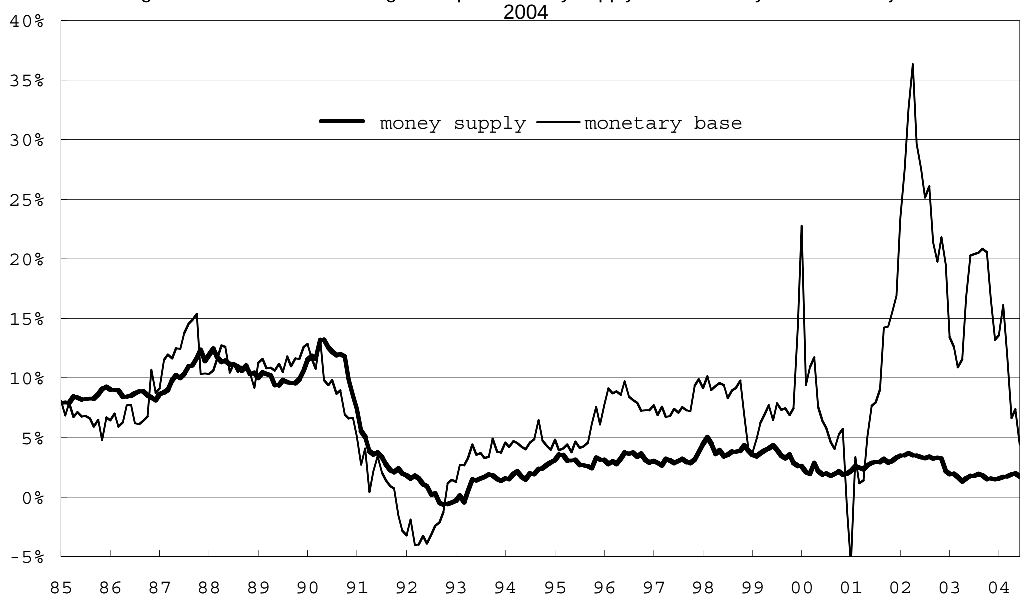
Figure 1. Rate of increase in Japan's consumer price index: 1990 - june 2004



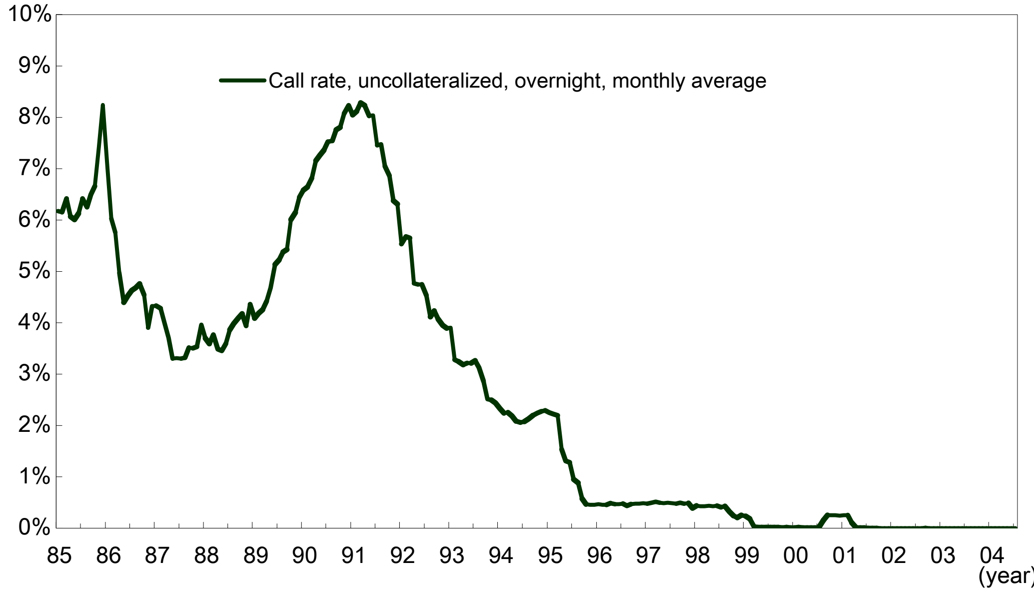
Source: Statistics Bureau of the Ministry of Internal Affairs and Communications

Figure 2. Annual rate of change in Japan's money supply and monetary base: 1985 - june 2004



Source: Bank of Japan

Figure 3. change in Japan's short-term money market rate: 1985 - june 2004



Source: Bank of Japan

Figure 4. Hits per year of the term "Defure (Deflation)" in the five biggest Japanese newspaper, Asahi, Mainichi, Yomiuri, Sankei, and Nikkei, by Nikkei Telecom 21 database

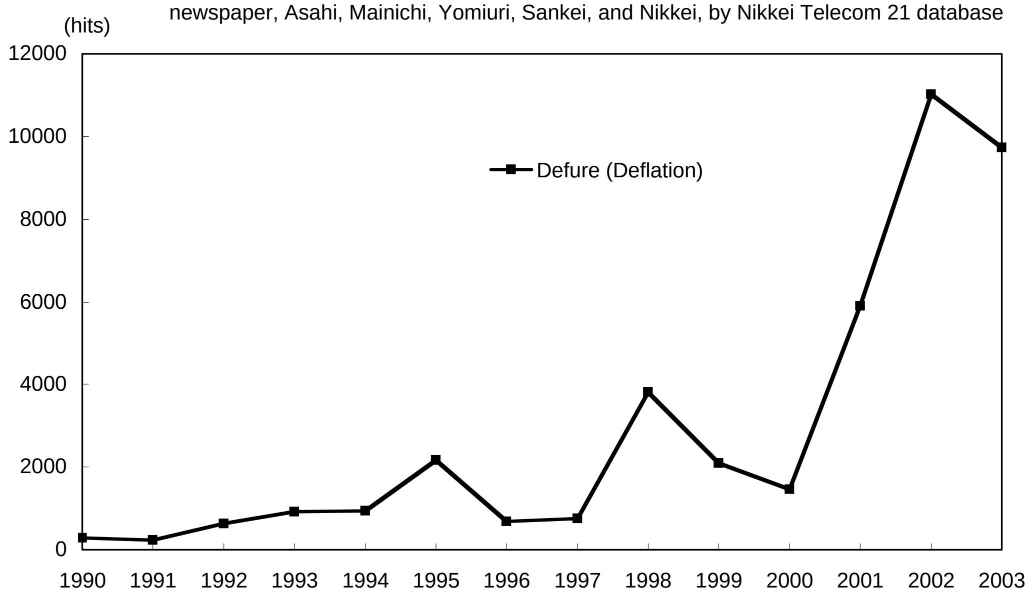


Figure 5. Hits per month of the term "Kozo Kaikaku (Structural Reform)" and "Defure Taisaku (Measures against Deflation)" in the five biggest Japanese newspaper, Asahi, Mainichi, Yomiuri, Sankei, and Nikkei, by Nikkei Telecom 21 database

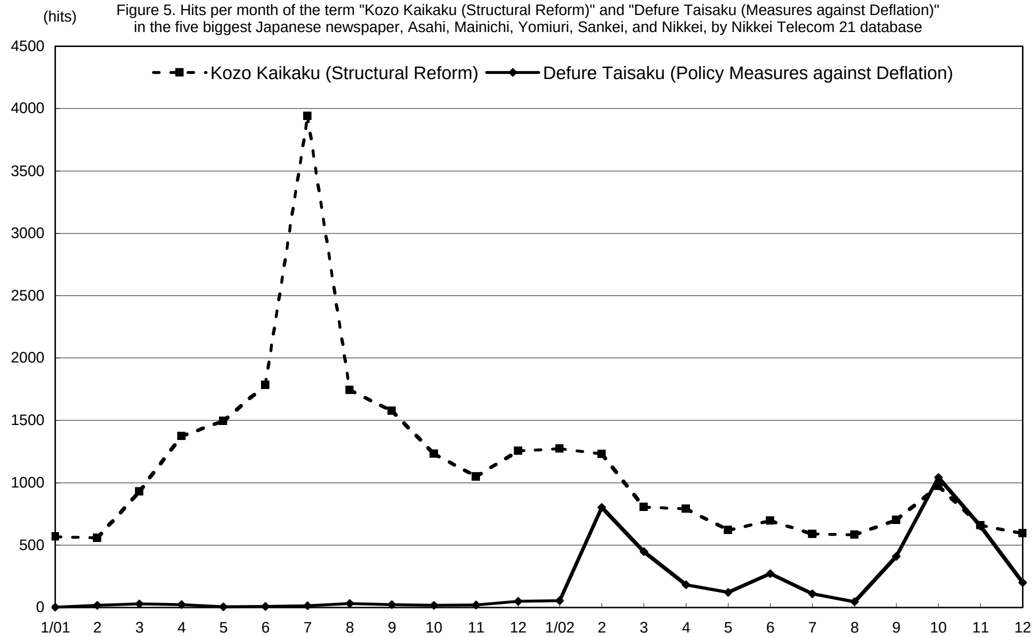


Table 1. The number of editorial articles from 2000 to 2003 that contain the word "deflation"

	Yomiuri	Asahi	Mainichi
2000	12	7	11
2001	90	7	20
2002	109	35	32
2003	90	34	39